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Elaine Hightower Gagliardi
Professor of Law, University of Montana School of Law, elaine.gagliardi@umontana.edu

ARTICLE

ECONOMIC SUBSTANCE IN THE CONTEXT OF FEDERAL ESTATE AND GIFT TAX:

THE INTERNAL REVENUE SERVICE HAS IT WRONG

Elaine Hightower Gagliardi*

I. INTRODUCTION

The taxpayer and the Internal Revenue Service[1] continue to engage in a battle over whether the "substance over form" doctrine applies to the determination of Federal estate and gift tax consequences.[2] A decisive victory has yet to be claimed, with

* Associate Professor of Law, Univ. of Montana School of Law; L.L.M. Taxation N.Y.U. School of Law (1990), recipient of the Harry J. Rudick Memorial Award for Distinction in the Graduate Tax Program; J.D. High Honors, Univ. of Montana School of Law (1985); B.A. Yale College (1982). The author would like to thank Professor J. Martin Burke for his guidance. In addition, the author thanks Michelle Milhollin for her research assistance, and Edward T. LeClaire for his thoughtful editorial comments.

1. Hereinafter the discussion refers to the Internal Revenue Service as the "Service."

2. The issue of form over substance in the Federal estate and gift tax context once again came to the forefront in the late 1990's with the popularity of the family limited partnership. As the battle heated up in 1996, several prominent estate planning commentators asserted during presentations at various estate planning continuing legal education programs that the substance over form doctrine had no application in the context of estate and gift tax planning. Their comments were triggered by the Internal Revenue Service's initial attack on valuation discounts taken with respect to the transfer

the taxpayer and the Service each winning at different stages of the skirmish.[3]

In its most recent attack on popular estate planning strategies, the Service has urged the courts to define substance by reference to the tax avoidance motive or intent of the taxpayer. Were the courts to declare victory in favor of the Service's subjective test, any certainty regarding the Federal estate and gift tax consequences of a transfer would be severely undermined. Courts should reject the Service's attack in favor of a more certain approach that defines economic substance in terms of the taxpayer's objective manifestations.

The Service, especially in the context of family limited partnerships, advances the argument that the estate plan must possess "economic substance." The Service sums up its analysis as follows:

> For more than 50 years, the courts have applied the economic substance doctrine, or a variant thereof, in the income tax context to disregard a diverse mix of transactions and entities that are devoid of economic substance other than the generation of tax benefits. The simple expedient of drawing up papers does not control for tax purposes when the objective economic realities are to the contrary. [Citations omitted.]
>
> In ACM Partnership, the United States Court of Appeals for the Third Circuit distilled the many economic substance cases into one

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of limited partnership interests. In a series of technical advice memoranda, the Service attacked those limited partnerships formed shortly before death as lacking substance. *See* Tech. Adv. Mems. 98-42-003 (July 2, 1998), 97-35-003 (May 8, 1997), 97-30-004 (Apr. 8, 1997), 97-25-002 (Mar. 3 1997), 97-23-009 (Feb. 24, 1997), 97-19-006 (Jan. 14, 1997). At that time the Service had not fully developed its form over substance argument in the context of the Federal estate tax. My initial reaction, as presented in a 1998 continuing legal education presentation, was that indeed substance was important and, that to achieve wealth transfer tax savings, the economic substance of the transaction must match the form of the transaction. *See, Form vs. Substance: Evaluating the Effectiveness of Various Estate Planning Devices*, Montana Tax Institute (1998). My definition of economic substance, however, differs substantially from the Service's current definition. The Service more fully developed its definition of economic substance in recent field service advice. I.R.S. FSA 2001-43-004 (Oct. 26, 2001); I.R.S. FSA 2000-49-003 (Sept. 1, 2000). *See also* I.R.S. FSA 2002-05-002 (Feb. 1, 2002).

3. Recent taxpayer victories include the court holdings in Church v. United States, 2000-1 U.S. Tax. Cas. (CCH) ¶ 60,369, 85 A.F.T.R.2d (RIA) 804, 2000 U.S. Dist. LEXIS 714 (W.D. Tex. 2000), *aff'd by unpublished opinion*, 268 F.3d 1063 (5th Cir. 2001) and Knight v. Commissioner, 115 T.C. 506 (2000). In those cases the courts upheld the validity of the family limited partnership despite the Service's lack of economic substance argument. Internal Revenue Service victories include Estate of Reichardt v. Commissioner, 114 T.C. 144 (2000), and Estate of Thompson v. Commissioner, T.C. Memo. 2002-246. In those cases the courts included the value of previously transferred partnership interests in the donor's gross estate based on the theory that the donor impliedly retained an interest in the transferred properties.

useful analysis:

> The inquiry into whether the taxpayer's transaction had sufficient economic substance to be respected for tax purposes turns on both the 'objective economic substance['] of the transactions (practical economic consequences, other than the creation of tax benefits) and the 'subjective business motivation' behind them (valid business purpose or profit motive) . . . These distinct aspects of the economic sham inquiry do not constitute discrete prongs of a 'rigid two-step analysis,' but rather represent related factors both of which inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes. [Citations omitted.][4]

The Field Service Advice acknowledges the "recent" unwillingness of the tax court to apply the economic substance doctrine in estate and gift tax cases.[5] It notes, however, that previous courts, including the tax court, have employed the economic substance doctrine to determine Federal estate and gift tax consequences. As an example, the Service points to the decision in *Estate of Murphy v. Commissioner*[6] where the tax court focused on the decedent's subjective intention to minimize estate tax by availing herself of a minority discount, and disallowed the discount because of the tax avoidance motive underlying the estate plan.[7] The economic substance doctrine as developed in the Service's Field Service Advice focuses on the taxpayer's tax savings motive in structuring the estate plan: "These cases imply that to show lack of economic substance, it is sufficient to show that tax savings was the primary purpose, not the sole purpose. The courts will not be confused by the presence of peripheral incidents that are imbued with economic substance."[8] Upon showing a lack of economic substance based on taxpayer's intent to avoid tax, the Service asserts the transaction should be ignored for purposes of the Federal estate and gift tax.

The Service, and those courts that have agreed with the Service, have inappropriately imported the income tax concept of economic substance to the Federal estate and gift tax. The difficulty with the Service's importation of income tax notions of

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4. I.R.S. FSA 2001-43-004 at 14-15 (Oct. 26, 2001), quoting ACM Partnership v. Comm'r, 157 F.3d 231, 248-49, 253-54 (3d Cir. 1998), *cert. denied* 119 S. Ct. 1251 (1999).

5. I.R.S. FSA 2001-43-004 at 16; I.R.S. FSA 2000-49-003 at 24.

6. Estate of Murphy v. Comm'r, 60 T.C.M. (CCH) 645, T.C.M. (RIA) 90472, 1990 Tax Ct. Memo LEXIS 520 (1990).

7. I.R.S. FSA 2001-43-004 at 19; I.R.S. FSA 2000-49-003 at 24-25.

8. I.R.S. FSA 2000-49-003 at 23.

economic substance lies with its focus on taxpayer's tax avoidance intentions and motives. Estate planning clients necessarily focus on the wealth transfer tax savings of making transfers, in addition to the donative purpose underlying the transfer.[9] To place primary emphasis on the tax savings intent or motive of the taxpayer creates a slippery slope that leads to the possibility of ignoring every estate planning transfer based on the Service's notion of whether the taxpayer's primary purpose was tax avoidance. The focus on intent unnecessarily increases the potential for litigation with the Service.

The Service also argues for importing the income tax notion of subjective business motivation or business purpose underlying the transaction. But this factor is generally inapplicable to estate planning transfers. Donative purpose, rather than business purpose, primarily underlies estate planning.

The Service historically has failed in its campaign to define economic substance in the context of Federal estate and gift tax in terms of taxpayer's intent. The United States Supreme Court recognizes the importance of focusing on objective factors. It rejects the notion that the determination of wealth transfer tax hinges on the taxpayer's intent or motive.[10] Congress also recognizes the difficulty in requiring the estate tax consequences to turn on taxpayer's tax avoidance motives. For example, Congress repealed the requirement that the gross estate include "a transfer . . . in contemplation of death,"[11] because the requirement resulted in a fact determination as to whether the decedent intended the transfer to be in contemplation of death. In its place Congress enacted a bright line rule including in the gross estate any transfer made within three years of death.[12] Objective criteria provide more certainty than subjective criteria focusing on intent and motive.

The United States Supreme Court and the Congress implicitly recognize the benefits of a policy encouraging estate tax consequences to turn on objective criteria that can be relied

9. As an estate planner, it would be remiss of me not to counsel my clients regarding the wealth transfer tax savings of making certain transfers to avoid tax.

10. United States v. Estate of Grace, 395 U.S. 316, 323 (1969); Estate of Spiegel v. Comm'r, 335 U.S. 701 (1949); Comm'r v. Estate of Church, 335 U.S. 632 (1949).

11. I.R.C. § 2035(a) (1976)

12. I.R.C. § 2035(a) (2002) (Section 2035 only picks up those transfers made during the three year period ending on the date of death, if the interest transferred or power relinquished would have been included in the gross estate under I.R.C. §§ 2036, 2037, 2038 or 2042 had decedent retained the interest or power).

upon by taxpayers to plan their estates. The policy of providing objective criteria minimizes the potential for costly litigation between the Service and taxpayers, and minimizes the enforcement burden of government. For these policy reasons, it would be a mistake for courts to uniformly adopt the Service's definition of economic substance, which would emphasize the tax avoidance motive and intent of the taxpayer.

In recognition of the need for imposition of an economic substance requirement in the determination of Federal estate and gift tax, this article proposes a different set of criteria for the determination of economic substance. The criteria are based solely on objective facts as manifested by the estate plan. The criteria derive from and follow the United States Supreme Court decisions that enunciate a common law of Federal estate and gift tax based on objective factors. The criteria also recognize that the Internal Revenue Code[13] imposes estate and gift tax based on the various property rights retained and transferred by the taxpayer. The transfer of a valuable property right, and not just the transfer of title to property, should trigger Federal estate and gift tax. As a corollary, the retention of a valuable property right by a decedent, that is transferable by decedent at death, should cause inclusion of the value of the property right in the decedent's gross estate. The test for economic substance proposed by this article would tax transferred property rights based on an objective test.

This article urges courts to adopt the following three criteria in determining whether a specific estate planning transfer possesses the necessary "objective" economic substance:

(1) Economic benefit criterion: Has a valuable economic benefit been transferred (or retained) as part of the estate planning transfer?

(2) Documentation criterion: Is the valuable economic benefit based on an enforceable legal right provided by law or by the estate planning documents?

(3) Implementation criterion: Do the objective actions of both the transferor and the beneficiary implement the enforceable legal rights, and respect the economic benefits associated with those rights?

Each of the three criteria that form the basis of the objective economic substance test derive from the case holdings of the

13. Hereinafter references to the "Code" are to the Internal Revenue Code of 1986, as amended.

United States Supreme Court, and the development of the common law of the Federal estate and gift tax. This objective economic substance test avoids the disadvantages of the intense factual inquiry and second guessing required by the Service's subjective intent based test of economic substance. It also provides workable guidance for development of an estate plan that courts should uphold.

The following discussion first develops the historic underpinnings for application of the objective economic substance test. Second, it develops the legal principals that provide the foundation for the three criteria of the test. Third, it evaluates those Federal wealth transfer tax court decisions that have strayed from the common law as developed by the United States Supreme Court and instead have adopted as the bell weather the Service's subjective intent based test of economic substance. Finally, it addresses the viability of current estate planning techniques in light of the objective economic substance test and the holdings of recent cases, and provides estate planners with guidance on how to structure a viable transfer that achieves minimization of Federal wealth transfer tax.

II. HISTORICAL UNDERPINNINGS OF THE FEDERAL ESTATE AND GIFT TAX DOCTRINE OF ECONOMIC SUBSTANCE

From the time of enactment of the first Federal estate tax, the taxpayer and the Service have contested issues of form versus substance. Initially the taxpayer prevailed in the United States Supreme Court. The Court taxed transfers based on the form of the transfer. The Service, however, not only held the line but eventually made substantial incursions into the Court's initial holding that compliance with the form required by the Code controlled the Federal estate and gift tax consequences of the wealth transfer. The following discussion places these early skirmishes in historical perspective.

A. *FORM CONTROLS EARLY DECISIONS*

Estate planners in the early part of the twentieth century relied on technical differences in title to obtain an estate tax savings. Planners focused on the moment when fee simple title passed from taxpayer to the beneficiary. If fee simple title passed prior to death, then the transfer escaped imposition of the estate tax. This resulted in less tax because at that time in history transfers during life occurred free of wealth transfer tax.[14]

The United States Supreme Court initially indicated that the critical moment for estate tax purposes was transfer of fee simple title. In *May v. Heiner*[15] decedent transferred property to a trust for the benefit of her husband during his life, then for the benefit of herself for her life, then to her children. The court stated:

> One may freely give his property to another by absolute gift without subjecting himself or his estate to a tax, but we are asked to say that this statute means that he may not make a gift inter vivos, equally absolute and complete, without subjecting it to a tax if the gift takes the form of a life estate in one with remainder over to another at or after the donor's death.[16]

The fact that title passed during life rather than at death was sufficient in the Court's view to exempt the transfer from estate tax and to reject the Service's argument that decedent made the transfer in contemplation of death. The Court in *May*, thus, allowed the form of the transfer to control the estate tax consequences.

The Court continued to focus on the form of the transfer in *Klein v. United States*[17] and in the St. Louis Union Trust Company cases, *Helvering v. St. Louis Union Trust Company*[18] and *Becker v. St. Louis Union Trust Company*.[19] Fifteen months before death the decedent in *Klein* transferred two parcels of property to his wife for life and retained a reversion in fee; thus, decedent's wife only took fee simple title if she survived decedent. The Court concluded that decedent's death "was the indispensable and intended event which" transferred fee simple title to decedent's wife.[20] The Court subjected the transfer to estate tax. In contrast, decedents in the *St. Louis Trust Company* cases transferred property to their children and

14. Congress enacted the first gift tax as part of the Revenue Act of 1924, Pub. L. No. 176, 43 Stat. 253, 313-316. The gift tax was short lived and repealed in 1926 as part of the Revenue Act of 1926, Pub. L. No. 20, 44 Stat. 125. The revenue needs created by the Great Depression caused Congress to reenact the gift tax as part of the Revenue Act of 1932, Pub. L. No. 154, 47 Stat. 169, 245.

15. May v. Heiner, 281 U.S. 238 (1930), *overruled by* Comm'r v. Estate of Church, 335 U.S. 632 (1949).

16. *Id.* at 244. (The Court quoted from its earlier decision in *Reinecke v. Northern Trust Co.*, 278 U.S. 339 (1929)).

17. 283 U.S. 231 (1931).

18. 296 U.S. 39 (1935), *overruled by* Helvering v. Hallock, 309 U.S. 106 (1940).

19. 296 U.S. 48 (1935), *overruled by* Helvering v. Hallock, 309 U.S. 106 (1940).

20. Klein v. United States, 283 U.S. 231, 234 (1931).

retained only a possibility of reverter. The Court concluded that fee simple title passed at the time of the transfer to the children and not at death. The court found "death simply put an end to what, at best, was a mere possibility of a reverter by extinguishing it; that is to say, by converting what was merely possible into an utter impossibility."[21] The transfers were not subject to estate tax. In *Klein* and in the *St. Louis Union Trust Company*, the Court arrived at two different estate tax results based on the form of the transaction, despite the similarity of the economic benefit retained by the decedent.

B. OPPOSITE HOLDINGS WITH RESPECT TO ECONOMICALLY SIMILAR TRANSFERS RESULT IN EVENTUAL FOCUS ON ECONOMIC SUBSTANCE

The opportunity to revisit the holdings of *Klein* and the *St. Louis Union Trust Company* cases arose in *Helvering v. Hallock*.[22] Decedent in *Hallock* transferred property during life and retained an interest in the form of a possibility of reverter. Retention of an interest in that form as opposed to a remainder in fee avoided imposition of estate tax pursuant to the holdings of the *St. Louis Union Trust Company* cases. The previous emphasis on form did not sit well with the *Hallock* Court.

The *Hallock* Court noted that no longer "does the issue turn on the unglossed text" of the statute.[23] The Court declined to recognize differences in the language of conveyance of title and departed from its previous reliance on form. The Court focused on substance: "In determining whether a taxable transfer becomes complete only at death we look to substance, not to form. . . . However we label the device it is but a means by which the gift is rendered incomplete until the donor's death."[24] The Court specifically disregarded the form of the retained interest, whether that of a remainder in fee or a possibility of reverter. It stated:

> The importation of these distinctions and controversies from the law of property into the administration of the estate tax precludes a fair and workable tax system. Essentially *the same interests, judged from the point of view of wealth*, will be taxable or not, depending upon elusive and subtle casuistries which may have their historic justification but possess no relevance for tax

21. Helvering v. St. Louis Union Trust Co., 296 U.S. 39, 43 (1935).
22. 309 U.S. 106 (1940).
23. *Id.* at 110.
24. *Id.* at 114.

purposes.[25]

The Court justified its departure from the *St. Louis Union Trust Co.* cases on the basis that it should not "persevere in distinctions taken in the application of a statute which, on further examination, appear consonant neither with the purposes of the statute nor with this Court's own conception of it."[26] The Court, thus, held the property includible in decedent's gross estate.[27]

The United States Supreme Court recognized that a continued focus on form of the transfer would result in anomalous results. The estate planner would simply need to call an interest by a different name in order to achieve estate tax savings. The *Hallock* Court clarified the need to subject economically similar transfers to the same estate tax burdens.

> In a final death blow to the notion that form and not economic substance controls the estate tax consequences of a transfer, the United States Supreme Court overruled *May v. Heiner*.[28] In *Commissioner v. Church's Estate*,[29] the Court extended the reasoning of *Hallock*: "And under the teaching of the Hallock case, quite in contrast to that of May v. Heiner, passage of the mere technical legal title to a trustee is not necessarily crucial in determining whether and when a gift becomes complete for estate tax purposes. Looking to substance and not merely to form, as we must unless we depart from the teaching of Hallock, the inescapable fact is that [decedent] retained for himself until death a most valuable property right in these stocks—the right to get and to spend their income."[30]

The Court held in *Church's Estate* that decedent's gross estate included the value of a trust in which decedent had

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25. *Id.* at 118 (emphasis added).

26. *Id.* at 122.

27. In a later case, *Fidelity-Philadelphia Trust Co. v. Rothensies*, 324 U.S. 108 (1945), the Court held that the full value of the property transferred during life was includible in the gross estate. It stated:

> "The taxable gross estate, in other words, must include those property interests the ultimate possession or enjoyment of which is held in suspense until the moment of the grantor's death or thereafter. [] Tested by that standard, the entire corpus of the trust should have been included in the decedent's gross estate and an estate tax levied on its net value at the date of decedent's death. The ultimate disposition of all the trust property was suspended during the life of the decedent."

Id. at 510. The Court again focused on the point in time at which the transfer of the economic benefit became final.

28. 281 U.S. 238 (1930), *overruled by* Comm'r v. Estate of Church, 335 U.S. 632 (1949).

29. 335 U.S. 632 (1949).

30. *Id.* at 644-645.

retained an income interest. It focused on retained economic benefit of the taxpayer, stating:

> "For from the viewpoint of the grantor the significant effect of this transaction was his continued enjoyment and retention of the income until his death; the important consequence to the remaindermen was the postponement of their right to this enjoyment of the income until the grantor's death."[31]

The focus on retained economic benefit originates in the requirements of the Code.[32]

Prior to its holding in *Hallock*, the Court in *Burnet v. Guggenheim*[33] had already focused on economic substance of the transfer in the context of the gift tax. During 1917, the taxpayer in *Guggenheim* transferred property in trust while reserving a power of revocation. Congress then enacted a gift tax as part of the Revenue Act of 1924.[34] In 1925 taxpayer canceled the power of revocation in an attempt to avoid application of the newly enacted gift tax. Taxpayer argued that he made a transfer for gift tax purposes when he transferred title to the trust in 1917, and the cancellation of the power to revoke was not a transfer contemplated by the gift tax statute. The court looked not to passage of title but to the economic substance of the transaction.

> 'Taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed—the actual benefit for which the tax is paid.' Corliss v. Bowers, 281 U.S. 327; [other citations omitted]. While the power of revocation stood uncancelled in the deeds, the gifts, from the point of view of substance, were inchoate and imperfect. . . . [The trusts] acquired substance and reality for the first time in July, 1925, when the deed became absolute through the cancellation of the power.[35]

The Court recognized that retention of command over the property allows control over enjoyment of the economic benefits afforded by the transferred property.

The holding of *Guggenheim* was consonant with the earlier holding of the Court in *Reinecke v. Northern Trust Company*,[36] an estate tax case. Decedent in *Northern Trust Company* transferred property to two trusts with respect to which he alone reserved a power of revocation, and also transferred property to

31. *Id.* at 641.

32. *See e.g.*, I.R.C. § 2036.

33. 288 U.S. 280 (1933).

34. The gift tax enacted in 1924 was repealed in 1926 and not replaced until 1932. *See* Revenue Act of 1924, *supra* note 14.

35. 288 U.S. at 283-84.

36. 278 U.S. 339 (1929).

five trusts with respect to which he reserved a power of revocation only with the consent of the trust beneficiaries. The Court included the two trusts as part of decedent's gross estate and excluded the five trusts based on an analysis of decedent's economic control over trust property. It noted:

> Nor did the reserved powers of management of the trusts save to decedent any control over the economic benefits or the enjoyment of the property. . . . The shifting of the economic interest in the trust property which was the subject of the tax was thus complete as soon as the trust was made. His power to recall the property and of control over it for his own benefit then ceased . . . .[37]

The holding emphasized that estate tax consequences depend upon the shifting of economic benefit from the transferor to the beneficiary. The Court shifted its focus from form to economic benefit. Transfer of economic benefit now determines Federal estate and gift tax consequences.

C. CONGRESS ALSO SHIFTED FOCUS TO ECONOMIC BENEFITS CONFERRED BY RIGHTS TO USE PROPERTY

Congress reacted to the holdings of the United States Supreme Court by amending the Federal estate and gift tax Code. Initially the Code defined the Federal estate and gift tax base to include (i) property subject to payment of creditors claims at death and (ii) property transferred in contemplation of death or transfer intended to take effect at death.[38] The Court's interpretation of these provisions allowed the form of the transaction to drive the tax consequences. Congress determined that the revenue cost of this interpretation was simply too great, and took steps to legislatively reverse the holdings of the United

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37. *Id.* at 346-47.

38. The 1916 estate tax Code included in the gross estate:

> "the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated: (a) To the extent of the interest therein of the decedent at the time of his death which after his death is subject to the payment of the charges against his estate and the expenses of its administration and is subject to distribution as part of his estate. (b) To the extent of any interest therein of which the decedent has at any time made a transfer, or with respect to which he has created a trust, in contemplation of or intended to take effect in possession or enjoyment at or after his death, except in case of a bona fide sale for a fair consideration in money or money's worth. Any transfer of a material part of his property in the nature of a final disposition or distribution thereof, made by the decedent within two years prior to his death without such a consideration, shall, unless shown to the contrary, be deemed to have been made in contemplation of death within the meaning of this title . . ."

Revenue Act of 1916, Pub. L. No. 271, 39 Stat. 756, 777 (1916).

States Supreme Court. In 1931, Congress amended the Code and it subjected to tax those property rights that confer economic benefit.[39]

In *Commissioner v. Church's Estate,*[40] the United States Supreme Court traced the history of the 1931 amendment to the Federal estate and gift tax Code:

> March 3, 1931, the next day after the three per curiam opinions were rendered, Acting Secretary of the Treasury Ogden Mills wrote a letter to the Speaker of the House explaining the holdings in May v. Heiner and the three cases decided the day before. He pointed out the disastrous effects they would have on the estate tax law and urged that Congress 'in order to prevent tax evasion,' immediately 'correct the situation' brought about by May v. Heiner and the other cases. 74 Cong. Rec. 7198, 7199 (1931). He expressed fear that without such action the Government would suffer 'a loss in excess of one-third of the revenue derived from the federal estate tax, with anticipated refunds of in excess of $25,000,000.' The Secretary's surprise at the decisions and his apprehensions as to their tax evasion consequences were repeated on the floor of the House and Senate. 74 Cong. Rec. supra. Senator Smoot, Chairman of the Senate Finance Committee, said on the floor of the Senate that this judicial interpretation of the statute 'came almost like a bombshell, because nobody ever anticipated such a decision.' 74 Cong. Rec. 7078. Both houses of Congress unanimously passed and the president signed the requested resolution that same day.[41]

The Code as it now exists incorporates the changes made by Congress in 1931. The Code taxes economic benefit conferred by rights and powers to property that together determine possession or enjoyment of the property transferred. If a transferor retains the right to income from the property, the right to time distribution of income or principal, the right to a reversionary interest in the transferred property or the right to alter, amend, revoke or terminate possession or enjoyment of

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39. By 1932 Congress had amended the estate tax Code to include in the gross estate:

> any interest therein of which the decedent has at any time made a transfer, by trust or otherwise, . . . under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death (1) the possession or enjoyment of, or the income from, the property, or (2) the right to designate the persons who shall possess or enjoy the property or the income therefrom; except in case of a bona fide sale for an adequate and full consideration in money or money's worth.

Joint Resolution to Amend Section 302 of the Revenue Act of 1926, 46 Stat. 1516 – 1517 (1931).

40. 335 U.S. 632 (1949).

41. *Id.* at 639-640.

property, then the property transferred is included in transferor's gross estate.[42] Each of the rights and powers taxed are valuable economic benefits. Retention of any of the enumerated economic benefits by the transferor appropriately triggers Federal estate tax.

III. EMERGENCE OF THE OBJECTIVE ECONOMIC SUBSTANCE TEST

From these initial clashes between the taxpayer and the Service and the Congressional response to those clashes, the objective economic substance test emerged. The United States Supreme Court has developed a common law of Federal estate and gift tax that focuses on the objective economic substance of a wealth transfer. The common law as traceable through the Court's pronouncements employs the three criteria of the objective economic substance test to define the substance over form doctrine in the area of Federal estate and gift tax. The following discussion focuses on the development of the three criteria: economic benefit, documentation and implementation.

A. ECONOMIC BENEFIT CRITERION: HAS A VALUABLE ECONOMIC BENEFIT BEEN TRANSFERRED (OR RETAINED) AS PART OF THE ESTATE PLANNING TRANSFER?

The United States Supreme Court insists on applying the Federal estate and gift tax Code in a manner that reaches all transfers of valuable economic benefit. Consonant with the Code provisions, it emphasizes taxing based on the value associated with the right to use or control property. This focus on economic benefits conferred by the various rights associated with the use or control of property forms the basis of the economic benefit criterion, which asks: Has a valuable economic benefit been transferred (or retained) as part of the estate planning transfer?

1. Interpretation of "Transfer" with Focus on Economic Benefit

The United States Supreme Court now broadly interprets the reach of the federal estate and gift tax Code based on the

42. I.R.C. §§ 2036, 2037, 2038 (2002).

statutory definition of "transfer."[43] The gift tax applies "whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible. . . ."[44] The language of the estate tax Code is equally as broad. The gross estate includes "the value at the time of [] death of all property, real or personal, tangible or intangible, wherever situated."[45]

In *Smith v. Shaughnessy*[46] the Court rejected taxpayer's argument that the gift tax did not reach transfer of a "contingent" remainder interest. The court found:

> The language of the gift tax statute . . . is broad enough to include property, however conceptual or contingent. And lest there be any doubt as to the amplitude of their purpose, the Senate and House Committees, reporting the bill, spelled out their meaning as follows: "The terms 'property,' 'transfer,' 'gift,' and 'indirectly' . . . are used in the broadest sense; the term 'property' reaching every species of right or interest protected by the laws and having an exchangeable value."[47]

The Court broadly construed transfers of property subject to the gift tax, despite the possibility that the same transfer of property could be subject to estate tax in the donor's estate.[48]

In a later case, *Dickman v. Commissioner*,[49] the Supreme Court reiterated its adherence to the principle that the gift tax Code applies to transfers of value, in whatever form. Taxpayers in *Dickman* made substantial interest free demand loans to their children. The Court agreed with the Commissioner that use of money at no charge constituted a gift to the extent of the value of the use of the loaned funds. The right to use loaned money confers an economic benefit. The Court concluded that the gift tax "was designed to encompass all transfers of property and property rights having significant value."[50] The Court rejected taxpayer's argument, based on the form of the transaction, that no gift occurred because taxpayer's children were obligated to return the loaned funds on demand.[51]

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43. *See, e.g.,* Smith v. Shaughnessy, 318 U.S. 176 (1943).

44. I.R.C. § 2511(a)(2002).

45. I.R.C. § 2031(a)(2002).

46. 318 U.S. 176, 180 (1943).

47. *Id.* at 180.

48. The Court noted the federal estate tax provides for the possibility of a credit for gift tax paid.

49. 465 U.S. 330 (1984).

50. *Id.* at 348-349.

51. Congress responded by enactment of I.R.C. § 7872 that provides a method for determining the value of any gift that results from a below market interest loan, and

Courts have extended this focus on transfers of rights conferring economic benefit beyond the facts of *Dickman*. For example, some courts hold that a transfer of property in exchange for an installment note with a present value less than that of the property transferred results in a gift for transfer tax purposes, regardless of whether safe harbor interest rules applicable to income taxation have been met by the terms of the note.[52] The Service has been eager to embrace this broad interpretation of economic benefit, as well. In a private letter ruling that it later withdrew, the Service ruled that a parent's personal guarantee of a bank loan to child for which there was no security constituted a gift.[53] Although never officially stated, the Service's withdrawal of its ruling likely stemmed from the difficulty of valuing the guarantee. These examples demonstrate the willingness of the courts, and the Service, to subject to wealth transfer tax even the most intangible of economic benefits conferred by the transfer of rights associated with property.

Courts are loath to limit the definition of property. The Fifth Circuit has noted that "we must remind ourselves that 'property' is an expansionist term."[54] In light of the broad definition of property transfers, application of the Federal estate and gift tax based on economic benefit associated with a valuable property right may be limited only by the inability of the Service and the courts to arrive at a definitive value, and even the inability to value the asset may not prevent application of estate or gift tax. The United States Supreme Court stated: "Even though these concepts of property and value may be slippery and elusive they can not escape taxation so long as they are used in the world of business."[55]

further provides for certain de minimus exceptions to the general rule that such a loan constitutes a gift.

52. Schusterman v. United States, 63 F.3d 986 (10th Cir. 1995); Krabbenhoft v. Comm'r, 939 F.2d 529 (8th Cir. 1991). *But see*, Ballard v. Comm'r, 854 F.2d 185 (7th Cir. 1988) (held no gift if safeharbor interest rules per applicable income tax statute met).

53. Priv. Ltr. Rul. 91-13-009 (Dec. 21, 1990), withdrawn by Priv. Ltr. Rul. 94-09-018 (Dec. 1, 1993). The initial ruling did not indicate how to arrive at the value of the guarantee for purposes of applying the estate and gift tax.

54. First Victoria Nat'l Bank v. United States, 620 F.2d 1096, 1102 (5th Cir. 1980) (held that a production right granted pursuant to a government crop control program fell within the definition of property because it was subject to transfer).

55. Smith v. Shaughnessy, 318 U.S. 176, 180 (1943). The Court in *Smith* held that inter vivos transfer of a contingent remainder interest was subject to gift tax and rejected the taxpayer's argument "that no realistic value can be placed on the contingent remainder and that it therefore should not be classed as a gift." *Id.* Congress, of course,

2. The Reciprocal Trust Doctrine Focus on Economic Benefit

The United States Supreme Court extended the holdings that the economic benefit conferred by a transfer, as opposed to its form, should control estate tax consequences to the situation where taxpayers create reciprocal trusts. In *United States v. Estate of Grace,*[56] a husband and wife, in anticipation of enactment of a gift tax, created reciprocal trusts: Joseph Grace created a trust naming himself as co-trustee and his wife Janet as life beneficiary, and Janet, in turn, created a trust naming herself as co-trustee and Joseph as life beneficiary.[57] The Court found the trusts were interrelated because the trusts were governed by substantially identical terms and were created at about the same time.[58] By their literal terms neither trust would have been included in the estates of Joseph and Janet Grace because neither of them retained any prohibited economic benefits in the trust of which they were trustor.[59] The Court applied the reciprocal trust doctrine to this planning technique "which seemingly avoid[s] the literal terms of [the taxing statute] while still leaving the decedent the lifetime enjoyment of his property."[60]

The Court uncrossed the trusts. It included in Joseph's gross estate the trust of which he was a beneficiary. The Court rejected a requirement that the trusts be established in consideration for the other.[61] It held that the trusts need only be "interrelated, and that the arrangement, to the extent of mutual value, leave the settlors in approximately the same economic position as they would have been in had they created trusts naming themselves as life beneficiaries."[62] The form of the transaction did not matter. The Court focused only on economic benefit objectively conferred:

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later responded by enactment of I.R.C. § 7520 (2002). Treasury promulgated regulations thereunder that provide a formula for determining the value of a contingent remainder.

56. 395 U.S. 316 (1969). The Court noted that several lower courts had already employed the reciprocal trust doctrine. *Id.* at 321.

57. During their marriage, Joseph transferred securities and real property to Janet. Janet used this property to fund the trust for her husband. *Id.* at 319.

58. *Id.* at 325.

59. I.R.C. §§ 2036 and 2038 only apply when the transferor of the property retains a prohibited economic benefit with respect to the property.

60. 395 U.S. at 320. The lower courts had employed the reciprocal trust doctrine in numerous cases. The United States Supreme Court employed the doctrine for the first time in *Grace*. *Id.*

61. *Id.* at 324.

62. *Id.*

It is also clear that the transfers in trust left each party, to the extent of mutual value, in the same objective economic position as before. Indeed, it appears, as would be expected in transfers between husband and wife, that the effective position of each party vis-à-vis the property did not change at all. It is no answer that the transferred properties were different in character. For purposes of the estate tax, we think that economic value is the only workable criterion.[63]

Essentially Joseph and Janet Grace retained enforceable legal rights to the same value of property as before creation of the trusts and, thus, were left in substantially the same financial position. The lack of substantive economic change persuaded the Court to require the property held in trust for their benefit be subject to estate tax.

The Sixth Circuit in *Green v. United States*[64] narrowly applied the holding of *Grace*. In *Green*, Jack Green created a trust for the benefit of his granddaughter Jennifer and named his wife Norma trustee; Norma, in turn, created a trust for the benefit of their granddaughter Greer and named her husband Jack trustee. Both trusts allowed trustee discretion to reinvest and time the distributions of corpus and income, discretion that if it had been retained by each of them as trustor would have caused inclusion of the trust assets in their respective gross estates. The court declined to apply the reciprocal trust doctrine to include the trust for the benefit of Greer in Jack's estate because Jack was not trustor of Greer's trust and because it found that neither Jack nor Norma were left in the same economic position because each had given property away to a grandchild.

Other courts have not arrived at the same conclusion as the Sixth Circuit in *Green*. The tax court in *Bischoff v. Commissioner*[65] applied the reciprocal trust doctrine to facts similar to those involved in *Green*. The tax court in *Bischoff* employed a two part analysis: (1) whether the transfers are interrelated and (2) whether benefits or powers retained would have been taxed absent the reciprocal technique. Both parts of the analysis focus on objective criteria. The tax court found that application of the reciprocal trust doctrine to reciprocal trusts with retained income interests but not to reciprocal trusts with retained powers over timing of distributions would create a

63. *Id.* at 325.

64. 68 F.3d 151 (6th Cir. 1995).

65. 69 T.C. 32 (1977).

perceived loophole.[66] The Federal Circuit court in *Exchange Bank and Trust Company of Florida v. United States*[67] followed the tax court's reasoning in *Bischoff* where spouses created reciprocal custodial accounts pursuant to the Florida Gifts to Minors Act for their children.

The reasoning of the tax court and of the Federal Circuit court is persuasive. The estate tax Code includes within the definition of taxable economic benefit the power to control the flow of income from transferred property.[68] The Seventh Circuit in its decision essentially ignored the broad scope of the taxing statute. Its holding allows form to control the tax consequences of the transaction, a notion previously rejected by the United States Supreme Court. The grandparents in *Green,* by using reciprocal trusts, were able to retain an economic benefit that with respect to any direct gift from grandparent to grandchild would have caused inclusion of the transferred property in the respective grandparent's estate. The Seventh Circuit allowed form of the transaction to undermine the purpose of the Code sections at issue.[69] Such a holding departs from the principle developed in United States Supreme Court decisions, including *Grace*, that economic value and the economic benefit conferred as defined by the estate tax Code is the only "workable criterion."[70]

The United States Supreme Court in *Grace* and the lower courts in *Bischoff* and *Exchange Bank and Trust Company of Florida* demonstrate a willingness to view interrelated transactions as one for purposes of determining economic substance of the estate planning technique. Reciprocal trust decisions turn on the objective facts indicating the trusts "were part of a single transaction designed and carried out by

66. *Id.* at 48.

67. 694 F.2d 1261, 1269 (Fed. Cir. 1982).

68. I.R.C. § 2036(a)(1) (2002).

69. Greene v. United States, 237 F.2d 848 (7th Cir. 1956). The Seventh Circuit holding in *Green* literally applied Section 2036 of the Code based on form of the transaction. Neither Jack Green nor Norma Green retained rights as transferor over the trusts to which they were named trustee. Taken literally, Section 2036 will not apply to include trust assets in the gross estate unless the transferor retains a prohibited power over the trust assets. Were the tax court or the Federal Circuit to address the facts in *Green*, those courts instead would have traced the economic benefits retained by Jack and Norma to the trusts with respect to which they were named trustee, uncrossed the transfers, and applied Section 2036 of the Code to include a portion of each trust in their respective gross estates.

70. Estate of Grace, 395 U.S. at 325.

decedent."[71] Those objective facts include the timing of the transfers, the amount of the transfers, and the actual economic benefit to each of the parties involved. Recent crossed gift decisions use an objective analysis of the resulting economic positions of the parties.[72] Those decisions refrain from using an analysis based on the taxpayer's intent or tax avoidance motive.[73] The United States Supreme Court has cited with approval cases that take "an inclusive view of the whole arrangement."[74]

B. DOCUMENTATION CRITERION: IS THE VALUABLE ECONOMIC BENEFIT BASED ON EITHER AN ENFORCEABLE LEGAL RIGHT PROVIDED BY LAW OR BY THE ESTATE PLANNING DOCUMENTS?

The United States Supreme Court decisions also clearly enunciate the rule that a transfer confers an economic benefit only to the extent that the beneficiary possesses enforceable legal rights to enjoy the economic benefit. This focus on enforceable legal rights provides an objective analysis. It rejects any analysis based on a taxpayer's intent or motive in making the transfer to confer the economic benefit. Once it is established that an economic benefit is the subject of the transfer, the documentation criterion becomes the focus: Is the valuable economic benefit based on an enforceable legal right provided either by law or by the estate planning documents? To answer this question, courts continue to employ the principal that objective economic substance should control tax consequences and not form.

The United States Supreme Court developed this criterion in *Commissioner v. Noel*.[75] In that case, decedent purchased accidental death life insurance prior to boarding a plane. He

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71. *Id.*

72. *Compare* Sather v. Comm'r, 251 F.3d 1168, 1175 (8th Cir. 2001) (Brothers made crossed-gifts to nieces and nephews on the same day); *and* Estate of Schuler v. Comm'r, 80 T.C.M. (CCH) 934, T.C.M. (RIA) 54171, 2000 Tax Ct. Memo LEXIS 465 (2000), *aff'd* 282 F.3d 575 (8th Cir. 2002) (Brothers made crossed-gifts to nieces and nephews that did not accomplish the stated business purpose of the transaction, which was to place the separate family businesses under the exclusive control of one brother's family), *with* Schultz v. United States, 493 F.2d 1225, 1226 (4th Cir. 1974)(court unnecessarily focused on actual intent, and indicated it need not reach the analysis of the Court in *Grace* which indicated that "'actual intent' was 'immaterial'")

73. *Supra* note 72.

74. United States v. Byrum, 408 U.S. 125, 148 (1972).

75. 380 U.S. 678 (1965).

asked the sales clerk to give the policies to his wife and said: "They are hers now, I no longer have anything to do with them."[76] Decedent's plane crashed and his wife received the proceeds. She asserted that decedent made a gift of the policies to her at the airport and thereafter retained no incidents of ownership over the policies.[77] The Court focused not on decedent's intent to make a gift but instead on the legal rights as set forth in the insurance contract.[78] The contract terms prohibited assignment or transfer without a written endorsement of the policy. Decedent was unable to make the assignment by written endorsement before boarding the plane. Up until the moment of death, decedent retained incidents of ownership over the policy under the legally enforceable terms of the policy because decedent failed to comply with the contract requirement that an assignment or transfer of the policy be made by written endorsement. An oral transfer was insufficient in substance, and for that matter, in form to divest decedent of economic benefit. The only legally enforceable way to transfer ownership of the life insurance policy was to deliver a written endorsement, and that was not done. The gross estate of decedent, thus, included the value of the policy proceeds.

In a later case, *United States v. Byrum,*[79] the Court focused on the legally enforceable power of decedent who transferred stock of closely held corporations and retained the right to vote the stock. Retention of such right, combined with stock owned outright by donor, afforded him voting control of the corporations at issue. The Service asserted that retention of the right to vote was tantamount to retention of a right to control distribution of income because decedent could determine the composition of the board of directors that in turn voted on whether to declare a dividend.[80] The Court rejected the Service's argument.

The *Byrum* Court found that decedent did not reserve the right to determine timing of the distribution of income.[81] It

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76. *Id.* at 680.

77. *Id.* at 679; *See also* I.R.C. § 2042 (2002), which includes in the gross estate the value of proceeds of an insurance policy over which decedent retained incidents of ownership. Incidents of ownership refers to the right to impact receipt of the economic benefits of the life insurance policy. The owner of the policy generally holds the incidents of ownership.

78. 380 U.S. at 682-684.

79. 408 U.S. 125 (1972).

80. *Id.* at 131.

81. *Id. See also* I.R.C. § 2036 (2002). Retention of such a right would have caused

stated:

> The term 'right,' certainly when used in a tax statute, must be given its normal and customary meaning. It connotes an ascertainable and legally enforceable power .... Here, the right ascribed to Byrum was the power to use his majority position and influence over the corporate directors to "regulate the flow of dividends" to the trust. That "right" was neither ascertainable nor legally enforceable and hence was not a right in any normal sense of that term.
>
> Byrum did retain the legal right to vote shares held by the trust and to veto investments and reinvestments. But the corporate trustee alone, not Byrum, had the right to pay out or withhold income and thereby to designate who among the beneficiaries enjoyed such income. Whatever power Byrum may have possessed with respect to the flow of income into the trust was derived not from an enforceable legal right specified in the trust instrument, but from the fact that he could elect a majority of the directors of the three corporations.[82]

The Court recognized that state law vested control over payment of corporate dividends in the board of directors.[83] The board is subject to fiduciary duties regarding payment of dividends.[84] Byrum himself, as a majority shareholder, owed a fiduciary duty to minority shareholders regarding operation of the corporation.[85] In addition, Byrum transferred the shares to a corporate trustee who alone controlled distribution of income from the shares held in trust. Because Byrum did not retain the legally enforceable right to control the flow of income under the terms of the trust agreement or applicable fiduciary duties, he did not retain a right that would cause inclusion under the estate tax provisions of the Code.[86]

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inclusion in the gross estate of decedent under Section 2036 of the Code.

82. 408 U.S. at 136-37. The Court emphasized that corporate directors were subject to a fiduciary duty to act in the interests of the corporation.

83. 408 U.S. at 141-42

84. *Id.*

85. *Id.*

86. Congress responded to the Court's holding in *Byrum* by enacting Section 2036(b) of the Code, known as the anti-Byrum amendment. Enactment of Section 2036(b) legislatively reversed the Court's holding in *Byrum*. Specifically, in the event decedent transfers stock and retains the right to vote the stock of a controlled corporation, the stock is includable in the gross estate. However, if decedent does not retain the right to vote the transferred stock, there is no inclusion even though decedent retains control of the corporation. The Senate Committee Report explains: " The rule would not apply to the transfer of stock in a controlled corporation where the decedent could not vote the transferred stock. For example, where a decedent transfers stock in a controlled corporation to his son and does not have the power to vote the stock . . ., the rule does not apply even where the decedent owned, or could vote, a majority of the stock. Similarly, where the decedent owned both voting and non-voting stock and

In both *Noel* and *Byrum* the United States Supreme Court analyzed the substantive legal rights retained by decedent in the contract or the trust document at issue to determine whether decedent retained economic benefit from the transferred property. Substance of the transaction, thus, depended on the objective enforceable terms of the governing agreement. It could be argued that at this point substance and form merge. The economic substance of the transaction draws definition from the form of the underlying contract. Yet at the same time, if transferor may not legally avail herself of an economic benefit, it would be inappropriate to ignore the substantive legal rights and infer a retention of economic benefit based on intent of the taxpayer. The opinions of the United States Supreme Court are in agreement. When faced with similar issues the circuit courts of appeal apply the same analysis.

The Sixth Circuit in *Estate of Sulovich v. Commissioner*,[87] held that the physical handing over of a passbook savings account without a corresponding change to the underlying contract with the bank was insufficient to avoid inclusion of the value of the account in decedent's gross estate. The court looked to whether decedent could retain control of the savings account pursuant to the terms of the legally enforceable contract with the bank. The savings account contract with the bank indicated that transfer could only be achieved by entering into a written contract changing ownership of the savings account. The physical handing over of the passbook did not meet the legal requirements of the contract. The court referred to the facts as "a situation where the substance of the transfer, and not the form, must control."[88] The economic substance of the transaction depended on the legally enforceable rights of the decedent pursuant to the contract governing the bank account.

The holding of the Ninth Circuit in *Crummey v. Commissioner*,[89] also focused on the legally enforceable rights of the trust beneficiaries to withdraw amounts from a trust. At

transferred the non-voting stock to another person, the rule does not apply to the non-voting stock simply because of the decedent's ownership of the voting stock." Senate Committee Report on Revenue Act of 1978, P.L. 95-600. *See also*, Prop. Treas. Reg. § 20.2036-2(a). Given this application, the anti-*Byrum* amendment does not impact the Supreme Court's analysis of fiduciary duty as set forth in *Byrum*.

87. 587 F.2d 845 (6th Cir. 1978).

88. *Id.* at 850.

89. 397 F.2d 82 (9th Cir. 1968).

issue was the ability of a donor to take an annual gift tax exclusion for gifts made in trust for the benefit of four children, three of which were minor beneficiaries. The trust terms specifically allowed the children to withdraw up to the annual exclusion amount transferred to the trust. If a beneficiary was a minor, the child's guardian could exercise the power of withdrawal on behalf of the minor. The Service allowed the annual exclusion gifts for transfers made subject to the withdrawal right of the adult beneficiary. The Service asserted the transfers subject to the withdrawal rights of the minor beneficiaries were future interests not eligible for the annual exclusion because it was unlikely that the demand right would be exercised on behalf of the minors. The Ninth Circuit rejected the Service's argument. The court noted that "the important thing was the right to enjoy rather than the actual enjoyment of the property."[90] The court concluded that as a technical matter the minor could legally enforce the withdrawal right by requiring appointment of a guardian. The court determined "all that is necessary is to find that the demand could not be resisted."[91]

The doctrine that substance and not form should control tax consequences, thus, has evolved in the estate planning context to mean that objective economic substance should control: legally enforceable rights to the economic benefit provides the basis of Federal estate and gift taxation. Legal enforceability derives both from enforceable terms of an agreement and from rights implied by law.

The emphasis of the United States Supreme Court decisions on objective economic substance derives from the Code, itself. The estate and gift tax provisions of the Code apply based on retained and transferred economic benefits, such as the right to receive or control distribution of income and other property rights.[92] It follows that to the extent the decedent retains a legally enforceable right to the economic benefits associated with the transferred property, the property should be included in decedent's gross estate. It follows, as well, that to the extent a donor transfers legally enforceable rights to the economic

90. *Id.* at 85.

91. *Id.* at 88.

92. The United States Supreme Court indicated: "More than once recently we have emphasized that "enjoyment" or "enjoy," as used in these and similar statutes, are not terms of art, but connote substantial present economic benefit rather than technical vesting of title or estates." Comm'r v. Holmes' Estate, 326 U.S. 480, 486 (1946).

benefits associated with the transferred property, the transfer should be included in the donor's taxable gifts.

C. IMPLEMENTATION CRITERION: DO THE ACTIONS OF BOTH THE TRANSFEROR AND THE BENEFICIARY IMPLEMENT THE ENFORCEABLE LEGAL RIGHTS, AND RESPECT THE ECONOMIC BENEFITS ASSOCIATED WITH THOSE RIGHTS?

The third criterion addressing implementation of the estate planning transfer has been developed primarily in the lower courts. Those courts have taken into account the emphasis the United States Supreme Court places on the transfer of economic benefits subject to legally enforceable rights. The implementation criterion asks: Do the actions of both the transferor and the beneficiary implement the enforceable legal rights, and respect the economic benefits associated with those rights? In other words, the parties must act in accordance with the legally enforceable rights transferred. To the extent that the objective manifestations and actions of the parties ignore or fail to implement the legally enforceable rights, courts imply an agreement between the transferor and the beneficiary. The courts re-characterize the transfer based on the objective manifestations of the parties. If the objective manifestations of the transferor and beneficiary allow the transferor to enjoy the economic benefits of the property despite a purported transfer, the courts will tax the property based on the retention of those benefits by the transferor.

Courts may imply an agreement between the transferor and the beneficiary that, after the gift, the transferor will retain certain benefits from the transferred property, even though the form of the transfer and substantive legal rights thereunder would not allow any such retention. Courts generally imply such an agreement where the transferor either neglects to follow the form of the transaction or ignores the substantive legal rights of the beneficiary. This analysis ensures that taxpayers objectively respect the economic substance of the transaction as required by the form of the transaction, and its associated legally enforceable rights.

The tax court found an implied agreement between the donor and beneficiaries in *Estate of Schauerhamer v.*

Commissioner.[93] Mrs. Schauerhamer transferred her assets to a family limited partnership and, in turn, transferred limited partnership interests to her children.[94] As general partner, Mrs. Schauerhamer proceeded to deposit partnership income in her personal account and in effect ignored the terms of the partnership and the legal rights of the limited partners to a proportional amount of the partnership income. The court included the transferred interests in Mrs. Schauerhamer's gross estate.[95] Despite the fact that the form of the transaction and the enforceable legal rights of the partners would preclude a retention of income from the gifted limited partnership interests by Mrs. Schauerhamer, the tax court found an implied agreement on the part of taxpayer and her children that she would retain the income from the transferred limited partnership interests because, after the gift of the limited partnership interests, Mrs. Schauerhamer in fact retained the income.[96] She failed to meet the implementation criterion. The court essentially re-characterized the transaction to recognize the actual retention of an economic benefit by Mrs. Schauerhamer.[97]

In an earlier case, *Estate of Guynn v. United States*,[98] the Fourth Circuit similarly employed the analysis required by the third criterion. In that case, Mom purchased a home, transferred the home by gift to her daughter and filed a gift tax return with respect to the transfer. Her daughter, who was also named personal representative of Mom's estate, argued that the home should not be included in Mom's gross estate. The Fourth

93. Estate of Schauerhamer v. Comm'r, 73 T.C.M. (CCH) 2855, 1997 Tax Ct. Memo LEXIS 276 (1997).

94. This estate planning technique purportedly allows the donor to retain some control over transferred assets as general partner. It also allows donor to transfer assets at a reduced value due to the minority position of a limited partner.

95. The court included the transferred partnership interests in donor's gross estate under Section 2036 of the Code.

96. Section 2036 of the Code requires inclusion in the gross estate of property over which the donor-decedent retained an income interest. *See also* Thompson v. Comm'r, 84 T.C.M. (CCH) 374, T.C.M. (RIA) 54890, 2002 Tax Ct. Memo LEXIS 254 (2002); Estate of Harper v. Comm'r, 83 T.C.M. (CCH) 1641, T.C.M. (RIA) 54745, 2002 Tax Ct. Memo LEXIS 127 (2002); Estate of Strangi v. Comm'r (Strangi III), T.C. Memo. 2003-145, 2003 Tax Ct. Memo LEXIS 144 (2003).

97. If Mrs. Schauerhamer, in her position as general partner, had made partnership distributions to herself and her children based on the proportional interest of each of the partners, the gifts made by Mrs. Schauerhamer would have achieved the intended wealth transfer tax savings. Distributions based on proportional interest would have implemented the enforceable legal rights of the beneficiary limited partners.

98. 437 F.2d 1148 (4th Cir. 1971).

Circuit rejected the daughter's argument. It emphasized the failure of Mom and her daughter to respect the enforceable legal rights associated with ownership of property. The court traced the events following the gift: Mom continued to reside in the transferred home as its sole occupant; Mom continued to pay for improvements and property taxes; and, the daughter did not pay for upkeep of the home nor did she receive any rent from Mom.[99] Based on these objective acts, the court implied an agreement that Mom would retain economic benefits to the home purportedly transferred to the daughter. The court found:

> Consistent with this mutual assumption, [Mom] retained all the attributes of ownership except bare legal title.... From every outward indication, [Mom's] relationship to the property was no different after the transfer to her daughter than before. Conversely, [daughter's] possession and economic enjoyment of the property was totally postponed until her mother's death. We hold, therefore, that the testimony of [daughter] and the actions of the parties establish an implied understanding that [Mom] would retain the possession and enjoyment of the property. . . .[100]

The court looked to the objective circumstances following the gift. Mom and daughter ignored daughter's substantive legal rights to receive rental payments from the home. Based on the objective economic substance of the transaction, the court included the home in Mom's gross estate.[101]

Enforcement of legal rights associated with economic benefits of the transferred property results in the court upholding the gift. In *Estate of Barlow v. Commissioner*,[102] decedent transferred the family farm to his three children and simultaneously entered into a lease for fair rental value with the children. The children could terminate the lease if rent was not timely paid. In deciding whether decedent and children impliedly agreed to allow decedent a retained interest in the farm at the time of the transfer, the court reviewed the objective events occurring after the transfer.[103] Although decedent failed

99. *Id.* at 1149.

100. *Id.* at 1150.

101. *Id.* The court included the home in the gross estate pursuant to Section 2036 of the Code.

102. 55 T.C. 666 (1971).

103. The tax court noted:

> This substance-versus-form argument, while theoretically plausible, depends upon the facts, and we do not think the record as a whole contains the facts required to give it life—to show that decedent retained possession or enjoyment . . . expressed or implied, of the kind referred to in section 2036.

Id. at 670.

to pay rent under the lease, the court found such failure could be explained by the fact that one child suffered from alcoholism and another was in the midst of a divorce. On decedent's death, the court highlighted the fact that the children filed a claim against decedent's estate for the unpaid rent. In contrast to the facts of *Guynn*, the beneficiaries in *Barlow* took steps to legally enforce their rights to the economic benefit from the transferred property and, although belatedly, in fact enforced their rights to such benefits by filing the claim for unpaid rent. Based on these objective facts the court rejected the Service's argument of an implied agreement between the donor and the beneficiary that donor would retain economic benefits from the transferred property.[104]

IV. COURTS SHOULD REJECT THE SERVICE'S INTENT BASED ECONOMIC SUBSTANCE ANALYSIS

The Service promotes adoption of an intent based approach to the determination of economic substance.[105] This approach ignores the holdings of the United States Supreme Court rejecting a subjective intent analysis in favor of objective criteria. An intent based test unnecessarily increases the potential for litigation by the Service. It also permits the Service to subjectively assess tax based on the Service's perception of the tax savings motive or intent of the taxpayer. In contrast, an objective economic substance analysis based on the three criteria enunciated in this article avoids the Service assessing a taxpayer's subjective motive or intent. The objective economic substance test denies estate tax savings in the context of abusive planning strategies, and at the same time protects those estate planning strategies conferring legally enforceable economic benefits in an effort to achieve wealth transfer tax savings.

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104. The court highlighted the enforceable rights of the children:

> By reason of the deed, they acquired the right to the economic benefits flowing from the ownership and use of the land—the right to a fair rental for its use. . . . However, decedent and petitioner were legally obligated, as tenants, to pay a fair, customary rental for the rights which they enjoyed, and the children were entitled, as landlords, to require the rent to be paid.

Id. at 670-671. The United States Supreme Court signaled the appropriateness of recognizing enforceable legal rights provided in the contract. Comm'r v. Noel, 380 U.S. 678 (1965).

105. *See, supra,* discussion accompanying notes 4 - 8.

A. UNITED STATES SUPREME COURT OPINIONS NEGATE AN INTENT BASED ECONOMIC SUBSTANCE ANALYSIS

The United States Supreme Court holdings consistently reject any analysis that relies on the transferor's motive or intent for making the transfer.[106] These holdings indicate a clear precedent against adoption of the Service's version of economic substance. The opinions of the United States Supreme Court outline a common law of estate planning as embodied in the three criterion of the objective economic substance test. Those criteria ensure that a legally enforceable economic benefit must transfer to achieve tax savings, and that the transferor and beneficiary must implement and respect the transfer of economic benefit. The opinions of the United States Supreme Court ignore taxpayer's tax avoidance motive or intent, in favor of taxpayer's objective manifestations.

In its decision in *Commissioner v. Church's Estate*,[107] the Court emphasized the objective economic substance of the transaction. It noted that as early as 1884, the Pennsylvania court appropriately imposed death taxes not based on intent, but on actual possession and enjoyment of the property. The Court stated: "It was further held in that case that the test of 'intended' was not a subjective one, that the question was not what the parties intended to do, but what the transaction actually effected as to title, possession and enjoyment."[108]

Again in *United States v. Estate of Grace*[109] the Court declined consideration of the intent of the parties in determining

106. Supreme Court cases addressing transfers in contemplation of death necessarily analyzed decedent's intent. Prior to its amendment in 1976, I.R.C. § 2035 (1976) required a determination of whether decedent made a transfer "in contemplation of death." In order to determine whether the transfer was made in contemplation of death the court had to determine whether "death [was] the impelling cause of the transfer." City Bank Farmers Trust Co. v. McGowan, 323 U.S. 594, 599 (1945). *See also*, Allen v. Trust Co. of Georgia, 326 U.S. 630 (1946); United States v. Wells, 283 U.S. 102, 118 (1931). This inquiry focused on taxpayer's intent and motive. Congress repealed this subjective test in favor of a bright line three year rule, that included in decedent's gross estate all gifts made within three years of death. I.R.C. § 2035 (1977). The rule was amended again in 1981, to delete the three year rule with respect to all transfers except the narrow class of transfers that would have been included under I.R.C. §§ 2036, 2037, 2038 or 2042, but for the transfer at issue. Congress through its amendment of I.R.C. § 2035, likewise, indicated its preference to avoid questions of intent in the family estate planning context.

107. 335 U.S. 632, 637 (1949).

108. *Id.* at 638.

109. 395 U.S. 316 (1969).

whether the reciprocal trusts created by husband and wife were includible in their respective gross estates. The Court stated:

> Emphasis on the subjective intent of the parties in creating the trusts, particularly when those parties are members of the same family unit, creates substantial obstacles to the proper application of the federal estate tax laws. As this Court said in Estate of Spiegel v. Commissioner of Internal Revenue:
>
> > 'Any requirement . . . (of) a post-death attempt to probe the settlor's thoughts in regard to the transfer, would partially impair the effectiveness of . . . (section 811(c)) as an instrument to frustrate estate tax evasions.'
>
> We agree that 'the taxability of a trust corpus . . . does not hinge on a settlor's motives, but depends on the nature and operative effect of the trust transfer.'[110]

The Court in *Grace* looked only to the objective facts to determine whether the trusts at issue were reciprocal.[111]

In both *Church's Estate* and *Grace*, the taxpayer urged the Court to consider the intent of the parties that a completed transfer occurred, and in conjunction, the absence of a tax avoidance motive of the taxpayer. The Court appropriately focused only on objective economic substance, because to do otherwise would lead to contradictory results. As demonstrated in the early Supreme Court decisions, *Klein v. United States*[112] and *The St. Louis Trust Company*[113] cases, a focus on either form or intent given the same objective facts can lead to inconsistent results. Nevertheless, the Service and some lower courts have failed to heed United States Supreme Court precedent rejecting any focus on taxpayer's intent or motive to achieve estate tax savings.

B. POLICY IMPLICATIONS ALSO NEGATE AN INTENT BASED ECONOMIC SUBSTANCE ANALYSIS

Good policy dictates Federal estate and gift tax provisions be consistently enforced. As demonstrated by these Supreme Court cases, an analysis that turns on the subjective intent of the taxpayer produces inconsistent tax results. Over the years both the Judiciary and Congress have recognized this difficulty

110. *Id.* at 323. (The Court quoted from its earlier decision in Estate of Spiegel v. Comm'r, 335 U.S. 701 (1949), and also cited its decision in Comm'r v. Estate of Church, 335 U.S. 632 (1949)).

111. *See supra,* discussion accompanying note 49.

112. 283 U.S. 231 (1931).

113. 296 U.S. 39 (1935) *and* 296 U.S. 48 (1935), both *overruled by*, Helvering v. Hallock, 309 U.S. 106 (1940).

and have endorsed an objective standard in the application of the Federal estate and gift tax. Objective factors relied upon by the three criteria outlined in this article avoid the subjective results of an intent based economic substance test.

It is not necessary to look further than the Service's use of the treasury regulations to demonstrate the possibilities for inconsistent enforcement of the Federal estate and gift tax based on the Service's intent based economic substance approach. Treasury has promulgated a gift tax regulation that provides:

> Donative intent on the part of the transferor is not an essential element in the application of the gift tax to the transfer. The application of the tax is based on the objective facts of the transfer and the circumstances under which it is made, rather than on the subjective motives of the donor.[114]

The Service relies on objective facts indicating a transfer of value to exact a gift tax when the taxpayer argues that a gift was not intended.[115] When convenient to its position, however, the Service turns a blind eye to the position taken in the regulation and urges courts to look at the subjective intent of the taxpayer to exact an estate tax in the event the taxpayer argues that a transfer should be respected for gift tax purposes and the Service argues it should not.[116]

The Service's argument, as set forth in recent field service advice, that a transaction lacks economic substance if the taxpayer's primary purpose was tax savings, flies in the face of Supreme Court precedent.[117] That precedent recognizes the need for predictable application of the Federal estate and gift tax provisions. In promoting its intent based economic substance test, the Service pays no attention to the broad policy implications of its analysis. Taken to its logical extreme, the intent based economic substance analysis would ignore for lack of economic substance any transfer undertaken by a taxpayer to minimize wealth transfer tax, despite objective facts indicating a transfer of economic benefit. In contrast, an analysis based on the three criteria of the objective economic substance test outlined in this article recognizes a taxpayer's right to engage in a tax savings transfer, so long as the taxpayer in fact transfers a legally enforceable economic benefit.

114. Treas. Reg. § 25.2511-1(g)(1) (2003).

115. *See*, Dickman v. Comm'r, 465 U.S. 330 (1984), discussed *supra* at note 42.

116. *See, e.g.*, Murphy v. Comm'r, 60 T.C.M. (CCH) 645, T.C.M. (RIA) 90472, 1990 Tax Ct. Memo LEXIS 520 (1990), discussed *infra* text accompanying note 135.

117. *See* I.R.S. FSA 2000-49-003 at 23.

C. SOME LOWER COURTS FAIL TO APPLY AN OBJECTIVE ECONOMIC SUBSTANCE ANALYSIS.

As authority for its intent based economic substance test, the Service relies upon a number of lower court cases that focus on a transferor's tax avoidance motive or intent to invalidate the estate planning transfer. Many of those cases involved what could be characterized as a abusive estate planning schemes. In each case, the lower court could have arrived at the same holding by applying an objective economic substance test based on the three criteria outlined. Those courts could have avoided the negative policy implications of an intent based tax avoidance focus, and still arrived at the "right" holding.

The most troubling aspect of the Service's intent based economic substance test is the ease with which strict application of the test can negate both abusive and non-abusive planning techniques.[118] The Service asserts this test in the context of main stream estate planning techniques, such as the *Crummey* withdrawal right and the family limited partnership.[119] Focus on the taxpayer's tax avoidance motive or intent imbues planning techniques with unnecessary uncertainty. In contrast, the objective economic substance test rejects the more subjective analysis asserted by the Service, and provides more certainty to the estate planning process.

The following discussion analyzes those cases most heavily relied upon by the Service as authority for the intent based economic substance analysis.[120] The discussion explains the application of the intent based economic substance analysis to the case facts. It then demonstrates the ability to arrive at the same holding with the more predictable objective economic substance test.

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118. The Service has indicated its willingness to attack certain types of abusive trust arrangements based on a substance over form analysis. I.R.S. Notice 97-24, 1997-16 IRB 6; *See also*, I.R.S. Tech. Adv. Mem. 96-28-004 (Jul. 12, 1996) (Citing *Heyen* and *Deal*, the Service indicated that the courts found "the taxpayers intended to do in substance something other than what they purported to do in form.").

119. *See*, Cristofani v. Comm'r, 97 T.C. 74 (1991). The Service also has aggressively asserted this approach in the context of family limited partnership, as evidenced by its statements in I.R.S. FSA 2000-49-003 (Sept. 1, 2000).

120. The Service also cites for support Schultz v. United States, 493 F.2d 1225 (4th Cir. 1974) discussed, *supra*, at note 72; and Griffin v. United States, 42 F. Supp.2d 700 (W.D. Tex. 1998) discussed, *infra*, at note 130.

1. Heyen v. Commissioner

One of the most heavily cited cases by the Service, is the Tenth Circuit's decision in *Heyen v. United States*.[121] In *Heyen*, decedent transferred stock in two different banks to 29 recipients, who were not members of decedent's family. The recipients endorsed the stock certificates in blank, and in turn the transfer agent reissued all the certificates in the names of members of decedent's family. This planning technique would avail decedent of 29 more annual gift tax exclusion amounts than were otherwise available. Later, it was discovered by the transfer agent that two of the recipients in fact had not endorsed the certificates in blank, and the transfer agent had to correct the mistake. The *Heyen* court found that "[t]he recipients either did not know they were receiving a gift of stock and believed they were merely participating in stock transfers or had agreed before receiving the stock that they would endorse the stock certificates in order that the stock could be reissued to decedent's family."[122]

The *Heyen* court focused on decedent's donative intent and subjective motives.[123] The court indicated that the treasury regulations do not preclude consideration of intent and motive to make a gift.[124] The court reasoned that donative intent suggests a gift. It found: "The evidence at trial indicated decedent intended to transfer the stock to her family rather than to the intermediate recipients."[125] It also found: "It was decedent's wish in transferring the stock that gift taxes be avoided."[126] The court held the gifts to the 29 recipients were not eligible for the annual gift tax exclusion because they were in fact indirect gifts to decedent's family.[127]

The *Heyen* court could have avoided the slippery slope of addressing taxpayer intent. It could have relied upon the objective economic substance test to reach the same result. The objective facts of *Heyen* indicate a failure to meet the

121. 945 F.2d 359 (10th Cir. 1991).

122. *Id.* at 361.

123. The *Heyen* court assessed a penalty for the fraudulent filing of a gift tax return. In order to prove fraud, the Service must demonstrate an intent to evade tax. *Id.* at 364. Focus on taxpayer's intent is entirely appropriate with respect to the issue of fraud.

124. *Id.* at 362.

125. *Id.* at 363.

126. *Id.* at 361.

127. *Id.* at 364.

implementation criterion. The implementation criterion requires the transferor and beneficiaries to respect the legally enforceable economic benefits subject to the transfer. An actual disregard of the legal rights of the beneficiaries negates any objective economic substance. The donor, along with the transfer agent, ignored the rights of the two recipients that did not endorse the stock certificates in blank. In addition, testimony at trial indicated:

> "[Taxpayer] contacted various initial stock recipients to determine whether they would be willing to effectuate retransfer of stock to family members. Other initial recipients, whom she had not previously contacted, were asked at the time the stock was transferred to them to sign their names to blank stock certificates to facilitate a stock transfer to family members."[128]

This testimony also indicates an implied agreement between the taxpayer and the recipients to ignore any legal rights of the recipients to the economic benefit of the stock certificates.

In a later, but similar case, *Estate of Bies v. Commissioner,*[129] the Tax Court cited *Heyen*. In *Bies*, like *Heyen*, the parent made annual exclusion gifts of family business stock to her two sons and two daughter-in-laws, and the daughter-in-laws pursuant to a prior agreement immediately transferred the stock received to their husbands, who were the donor's sons. The parent declined to make similar annual exclusion gifts to her daughters because they were not involved in the family business. The court noted that the daughters-in-law, like the daughters, also were not involved in the family business. Although the court cited *Heyen*, it did not adopt the "intent" reasoning applied in *Heyen*. Rather the Tax Court appropriately reasoned that the objective facts of the simultaneous transfers demonstrated a pre-arranged plan, and collapsed the steps into a single transaction.[130] The court traced the economic benefit, which in this case was the cash, to determine the true donee.

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128. *Id.* at 365. Based on this testimony, the appeals court affirmed liability for the fraud penalty assessed by the Service. The court stated: "As a whole, the time and manner of the transfers and plaintiff's actions, along with her sophistication regarding the tax matters at issue, are consistent with a finding that she intended to evade taxes." *Id.* The court defined fraud for purposes of assessing a penalty as an "intentional wrongdoing, and the intent required is the specific purpose to evade a tax believed to be owing." *Id.* at 364.

129. 80 T.C.M. (CCH) 628, T.C.M. (RIA) 54105, 2000 Tax Ct. Memo LEXIS 398, 11 (2000).

130. *Id.* at 12. *See also*, Griffin v. United States, 42 F. Supp.2d 700 (W.D. Tex. 1998)(Court applied a similar analysis and ignored the transfer to an intermediary for the purposes of obtaining a minority discount.).

The court essentially applied both the economic benefit and the implementation criteria to invalidate the transaction.

2. Deal v. Commissioner

The Service also relies on the holding of *Deal v. Commissioner.*[131] The taxpayer in *Deal* transferred unimproved land to a trust. Pursuant to the terms of the trust, taxpayer retains a life income interest, and the daughters receive the property remaining in the trust on taxpayer's death. At the time of transfer, each of her four daughters executed four separate unsecured non-interest bearing demand notes equal to the annual gift tax exclusion. The sum of the notes equaled the value of the land transferred to the trust. Taxpayer forgave four of the notes on December 30, the day after the transfer to the trust. Five days later on January 5, she forgave four more of the notes. She forgave the remaining notes in early January of the following years until the purchase price was fully forgiven.[132] Taxpayer asserted she sold the property to her daughters.

The court emphasized the intent of taxpayer:

> After carefully considering the record, we think that the notes executed by the daughters were not intended to be enforced and were not intended as consideration for the transfer by the [taxpayer], and that, in substance, the transfer of the property was by gift. There is no evidence that [taxpayer] intended to sell the property to her daughters. On the contrary, a donative intent is evidenced.[133]

The court pointed to the fact that more than one-half the value of the notes were canceled within six days of the transfer in trust. It characterized the notes as a "mere device" to avoid gift tax.[134] The court disregarded taxpayer's argument that the daughters were legally liable on the notes.[135]

Rather than focusing on intent, the tax court could have

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131. 29 T.C. 730 (1958).

132. *Id.* at 734.

133. *Id.* at 736.

134. *Id.*

135. The Service indicated its approval of *Deal* in Rev. Rul. 77-299, 1977-2 C.B. 343. Indicative of its position, it stated: "Thus, in the instant case, whether the transfer of property was a sale or a gift depends upon whether, as part of a prearranged plan, G intended to forgive the notes that were received when G transferred the property. It should be noted that the intent to forgive notes is to be distinguished from donative intent, which, as indicated by section 25.2511-1(g)(1) of the regulations, is not relevant. A finding of an intent to forgive the note relates to whether valuable consideration was received and, thus, to whether the transaction was in reality a bona fide sale or a disguised gift." See also Rev. Rul. 81-286, 1981-2 C.B. 177 (1981).

more appropriately focused on the economic benefit and implementation criteria of the objective economic substance test. The court could have based its decision on the economic benefit criterion. The non-interest bearing and unsecured nature of the demand notes demonstrate the transfer of economic benefit to the daughters and conversely the lack of a clear legal right to any economic benefit retained by the taxpayer. In addition, the court could have found a failure of the implementation criterion based on the objective facts that taxpayer and her daughters had an implied agreement to ignore the terms of the notes. The facts indicate more than half the value of the non-interest bearing and unsecured notes was forgiven within six days of the transfer. The writing of the notes and the almost immediate forgiveness of more than half of the purchase price amounted to a disregard of the legal rights the notes represented. The analysis based on the objective economic substance test avoids the need to make the difficult determination of subjective intent among family members.

Addressing similar facts, other courts have focused on whether the objective facts of the transaction indicate an implied agreement to ignore the legal rights of the transferor as evidenced by the notes.[136] A number of courts have approved notes that were secured by a mortgage, and have relied on the objective criterion that the secured interest evidences a bona-fide creditor-debtor relationship.[137] Court decisions that focus on objective criteria evidencing legally enforceable rights to economic benefits are less likely to lead to inconsistent decisions than those decisions that focus on the subjectiveness of taxpayer's intent. This is because those courts enunciate certain factors that can be relied upon to imbue the estate planning transfer with economic substance.

3. *Murphy v. Commissioner*

The facts of *Murphy v. Commissioner,*[138] a case often cited by the Service, involved a family corporation. Eighteen days

136. *See, e.g.,* Miller v. Comm'r, 71 T.C.M. (CCH) 1674, 1996 Tax Ct. Memo LEXIS 5 (1996), *aff'd* 97-1 U.S. Tax Cas. (CCH) ¶60,277, 79 A.F.T.R.2d (RIA) 2843, 1997 U.S. App. LEXIS 11426 (9th Cir., 1997); Kelley v. Comm'r, 63 T.C. 321 (1974); Haygood v. Comm'r, 42 T.C. 936 (1964); Wilson v. Comm'r, T.C. Memo 1992-480.

137. Kelley v. Comm'r, 63 T.C. 321 (1974); Haygood v. Comm'r, 42 T.C. 936 (1964); Wilson v. Comm'r, T.C. Memo. 1992-480.

138. 60 T.C.M. (CCH) 645, T.C.M. (RIA) 90472, 1990 Tax Ct. Memo LEXIS 520 (1990).

before decedent in *Murphy* died of cancer, she transferred an 0.88 percent interest in their family corporation to each of her children, and, thus, retained only a 49.6 percent minority interest. The taxpayer argued that retention of a less than 50 percent interest resulted in substantial estate tax savings because such an interest is much less valuable than an interest in which the transferor controls the company. The court cited extensively from letters decedent received from her tax adviser detailing the dramatic estate tax savings that would result from such a transfer, and minimizing the potential loss of control by assuring decedent that she and her children would still retain control of the company.[139]

The court determined decedent's "sole and explicit purpose [was] to obtain a minority discount."[140] Citing two United States Supreme Court cases that addressed valuation of interests for purposes other than the federal estate tax, the tax court held: "A minority discount should not be applied if the explicit purpose and effect of fragmenting the control block of stock was solely to reduce Federal tax."[141] The tax court, thus, disallowed any valuation adjustment for the minority character of the interest retained by decedent.

The *Murphy* court prefaced its reasoning by stating: "We do not apply family attribution in reaching this result, and we believe our result is fully consistent with the 1981 amendments to section 2035."[142] The court, however, proceeded to do just that — apply family attribution and ignore the 1981 amendments to Section 2035 of the Code eliminating the statute's prior intent based focus. To support its decision that the stock transfer in *Murphy* lacked substance the court highlighted the continuation of family control as a factor. It stated:

> "During the 18-day period between the lifetime gifts of the stock to decedent's two children and her death, decedent continued to be chairman of the board and her two children held the two top management positions. We believe that all concerned intended nothing of substance to change between the time of transfer and the time of her death, and that nothing of substance did change."[143]

It also noted that "there was [an] implicit understanding among

139. 1990 Tax Ct. Memo LEXIS 520 at 15-16.

140. 1990 Tax Ct. Memo LEXIS 520 at 52.

141. 1990 Tax Ct. Memo LEXIS 520 at 54.

142. *Id.*

143. 1990 Tax Ct. Memo LEXIS 520 at 58.

all concerned to retain control of the business."[144] The court referenced a number of pre-1993 holdings that disallowed minority discounts in the family context. It did not, other than in its prefacing statement, make even indirect reference to the Service's 1993 revenue ruling allowing minority discounts with respect to transfers to family members.[145] Nor did it recognize, as did the 1981 amendments to Section 2035 of the Code, that transfers immediately before death are no longer to be treated as if made in contemplation of death except in limited circumstances.

The *Murphy* court took a step no other court has taken in the determination of the Federal estate and gift tax when it held that because decedent's "explicit purpose . . . was solely to reduce estate tax," the transfer would be ignored for estate tax purposes.[146] The court likely took that step because it would be difficult to ignore the transfer of the 0.88 percent interest given the existing precedent against family attribution and the 1981 amendment of Section 2035 of the Code.

Applying the objective economic substance test to the facts in *Murphy* admittedly would have presented the court with a difficult decision. The gift of the 0.88 percent interest in shares effectively transferred title to the children. The court questioned, however, whether valuable economic benefits actually transferred. At the time of the transfer, decedent was diagnosed with cancer and died 18 days later, her position on the board did not change after the transfer and neither did the positions of her children. The transfer was not made until the last possible moment given decedent's declining physical state. Also, the trustee of the children's trusts, that had previously received gifts of stock, assured decedent it would follow her wishes as trustor.[147] This assurance by the trustee is an objective factor indicating that the control decedent and her family exerted would not changed because of the transfer.[148] Control is the economic benefit typically given up to achieve minority discounts. Rather than basing its holding solely on decedent's tax avoidance motive, the court could have found the implementation criterion lacking.

144. 1990 Tax Ct. Memo LEXIS 520 at 60.

145. Rev. Rul. 93-12, 1993-1 C.B. 202.

146. 1990 Tax Ct. Memo LEXIS 520 at 54.

147. *Id.* at 57.

148. The court referred to the continued control of decedent and her family several times in the opinion. *Id.* at 23, 58, 74, 75.

D. THE STRUCTURE OF THE FEDERAL ESTATE AND GIFT TAX ESCHEWS AN INTENT BASED ECONOMIC SUBSTANCE ANALYSIS

Very few courts have adopted the intent based economic substance argument asserted by the Service. Most courts rely on an analysis that questions whether any of the three criteria of the objective economic substance test is missing. Objective criteria correlate most closely with the provisions of the Code. In contrast, a focus on taxpayer intent to avoid tax disregards the very nature of what the Code subjects to tax.

As recognized by the economic benefit criterion of the objective economic substance test, the Code taxes transfers of property with significant value. For estate and gift tax purposes, property consists of a bundle of rights. To the extent a valuable property right is transferred for less than adequate consideration, the transferor has made a transfer subject to federal estate and gift tax. The taxing statute does not take into account whether the transferor subjectively intended to make a transfer. It taxes the actual transfer of an economic benefit.

Transferors generally document the rights transferred by written trust or other agreement. The document sets forth the legal rights transferred.[149] If the beneficiary may legally enforce an agreement, such as a trust or contract, it follows that the transferor has transferred the rights and economic benefits provided in the trust or other agreement for purposes of applying the gift tax (or, if the transfer is on death, the estate tax). The documentation criterion recognizes the necessity of enforceable legal rights to the economic benefit transferred. Only to the extent the parties ignore the enforceable legal rights documented in the agreement should the transfer be ignored for transfer tax purposes. The implementation criteria ensures that the transferor and beneficiary implement the transfer in accord with the legally enforceable rights.

Focus on taxpayer's subjective tax savings intent, as opposed to objective circumstances, adds an element not present in the statutory language. To the extent the transferor gives

149. The Tenth Circuit in *Davenport v. Comm'r*, 184 F.3d 1176, 1187-88 (10th Cir. 1999) reviewed the objective factors in order to determine whether a donor in fact made a gift of stock. The court noted the written deed of gift evidencing a transfer, the relinquishment of the donor's right to vote the stock, and the issuance of dividends to the donee as objective evidence that the donor intended a gift of stock. The Tenth Circuit appropriately focused on these objective facts to determine if the form and economic substance indicated a gift.

away a property right without receiving consideration, a taxable event occurs for wealth transfer tax purposes. The lack of adequate consideration for the transfer indicates donative purpose. As a consequence the courts should limit any inquiry to whether the objective facts and circumstances indicate the transfer of a legally enforceable economic benefit for less than adequate consideration. The objective economic benefit test achieves this goal.

VI. APPLICATION OF COMMON LAW PRINCIPLES TO POPULARIZED ESTATE PLANNING TECHNIQUES

The law should be interpreted in a predictable manner. Estate planning transactions especially depend on a consistent and predictable application of the Code. Ignoring a transfer based on a taxpayer's tax avoidance motive, as urged by the Service, allows the Service to subjectively enforce the estate and gift tax provisions of the Code.

The vast majority of courts, including the United States Supreme Court, recognize this need for predictability. Those courts, as indicated by the following discussion, determine the validity of popular estate planning techniques based on the criteria that comprise the objective economic benefit test outlined in this article. For the sake of predictability, courts should continue to employ these criteria, and to reject application of the Service's intent based economic substance test in the context of Federal estate and gift tax.

A. THE CRUMMEY DEMAND POWER

One of the most popular estate planning techniques is use of the *Crummey* withdrawal power, named after the seminal case approving its use.[150] The *Crummey* withdrawal power allows a donor to obtain the benefit of the annual gift tax exclusion and, at the same time, allows the donor to place property in trust and thereby control its future use.

1. Estate Planning Opportunities

Specifically, the gift tax annual exclusion allows a donor to transfer by gift up to $10,000 (as that amount is indexed for inflation) to an individual donee each year without incurring

150. Crummey v. Comm'r, 397 F.2d 82 (9th Cir. 1968); *see also, supra* discussion accompanying note 89.

any Federal wealth transfer tax consequences.[151] For example, a client could give $10,000 in cash outright to each of ten grandchildren this year, and, thus, dispose of $100,000 of her estate without any wealth transfer tax consequences. The client could do the same thing next year, and each year thereafter. By aggressively making annual exclusion gifts, a moderately wealthy client can avoid any imposition of Federal gift or estate tax. The only wrinkle is the necessity that the transfer by gift be one of a present and not a future interest.[152]

The gift tax annual exclusion is denied for gifts of future interests. The United States Supreme Court approved the Treasury Regulation definition of future interest which includes those interests "limited to commence in use, possession, or enjoyment at some future date or time."[153] Coinciding with this definition, the Treasury Regulations define present interest as "[a]n unrestricted right to the immediate use, possession, or enjoyment of property or the income from property. . . ."[154] The United States Supreme Court has held that the donee must obtain a substantial present economic benefit from the transferred property in order for the donor to obtain the benefit of the gift tax annual exclusion.[155] Thus, without the *Crummey* withdrawal power it would be difficult to obtain an annual exclusion for gifts of property in trust.[156]

The *Crummey* withdrawal power allows a beneficiary a specified period of time to withdraw property from a trust, and thereby obtain its immediate possession. In general, the

151. I.R.C. § 2503(b) (2002). The gift tax annual exclusion as indexed for inflation increased to $11,000 as of 2002. Rev. Proc. 2001-59, 2001-52 I.R.B. 623.

152. I.R.C. § 2503(b) (2002); Treas. Reg. § 25.2503-3(a) (2002).

153. Comm'r v. Disston, 325 U.S. 442, 446 (1945); Treas. Reg. § 25.2503-3(a).

154. Treas. Reg. § 25.2503-3(b).

155. Fondren v. Comm'r, 324 U.S. 18, 20 (1945). The United States Supreme Court held that where as in *Fondren* the donee's right to the income or use of the property is subject to the discretion of a trustee, the gift is one of a future interest. *Id.* at 21. In that case, the trust directed that the trustee "shall provide for the support, maintenance and education . . ., using only the income of said estate for the purpose if it be sufficient." *Id.* at 22. In an earlier case, *Ryerson v. United States*, 312 U.S. 405, 408 (1941), the United States Supreme Court held that where the donee had to join with another in order to access property held in trust, the gift was also of a future interest. In that same case, the Court disallowed an annual exclusion for the income interest because the corpus of the trust was a life insurance policy that would not produce income until the death of the donor. *Id.* at 409.

156. If the trust required the trustor to distribute to the beneficiary all income of the trust, the donor could claim a gift tax annual exclusion for the present value of the income interest. Treas Reg. § 25.2503-3(b). Most clients, however, prefer that income be accumulated during the minority of a beneficiary.

transferor places property in trust, and for a certain number of days (usually thirty) the trust beneficiary may withdraw the amount of the transfer up to the allowable Federal gift tax annual exclusion. If the beneficiary does not withdraw the transferred property within that time period, the withdrawal right ceases and the transfer becomes subject to the terms of the trust. The withdrawal right confers upon the beneficiary the legal right to obtain the immediate use and possession of the gift to the trust, and qualifies for the gift for the annual exclusion. Few, if any, beneficiaries in fact exercise the withdrawal right; thus, the property transferred becomes subject to the trust terms.

2. Objective Economic Substance Analysis Employed

The courts implicitly have applied the objective economic substance analysis as it has emerged in the decisions of the United States Supreme Court to uphold *Crummey* withdrawal rights, despite the Service's substance-over-form attack. In response to the Service, the courts initially emphasized the legal enforceability of the beneficiary's right to withdraw property from the trust on demand, the documentation criterion. The courts and, in particular, the Ninth Circuit, have consistently rejected the Service's focus on whether the trustor or the beneficiaries ever in fact intended that the beneficiary would withdraw property from the trust. Instead, the courts focus on the legal right of the beneficiary to withdraw and, thus, in substance obtain the economic benefit of the transfer.

The Ninth Circuit in *Crummey v. Commissioner* held that a minor beneficiary's right to demand withdrawal of trust property for a specific period of time qualified for the gift tax annual exclusion.[157] In *Crummey*, taxpayers created an irrevocable trust for the benefit of their four children, two of them minors. The trust allowed each child to withdraw up to the annual exclusion amount upon transfer to the trust. The right of withdrawal terminated December 31 of each year. The guardian of a minor child could exercise the power of withdrawal on behalf of the child. The Service asserted the transfers to the minors were future interests, but allowed the annual exclusion with respect to the withdrawal rights of the adult beneficiaries.

The Ninth Circuit, addressing the withdrawal right of the

157. 397 F.2d 82 (9th Cir. 1968).

minor beneficiaries, reasoned: "the important thing was the right to enjoy rather than the actual enjoyment of the property."[158] The Ninth Circuit disregarded the intentions of trustors to create a long term trust, and concluded:

> It becomes arbitrary for the I.R.S. to step in and decide who is likely to make an effective demand. Under the circumstances suggested in our case, it is doubtful that any demands will be made against the trust—yet the Commissioner always allowed the exclusion as to adult beneficiaries.[159]

The court decided in favor of a bright line rule, and allowed the gift tax annual exclusion because it was in fact possible for the minors to petition for the appointment of a guardian to exercise the withdrawal right on the minor's behalf. (Implicit in this holding is the understanding that the guardian is subject to a fiduciary duty to act in the best interests of the minor.) In other words, it was possible for the minor beneficiaries to legally enforce the withdrawal right, as required by the economic benefit and documentation criteria.

The tax court in *Cristofani v. Commissioner*[160] applied an analysis similar to that in *Crummey* to approve the gift tax annual exclusion for withdrawal rights held by contingent trust beneficiaries, who would very likely never receive any trust property.[161] In *Cristofani*, taxpayer gave *Crummey* withdrawal rights not only to the primary income beneficiaries of the trust (who would in all likelihood receive all the trust property on termination of the trust), but also to the contingent remaindermen. Taxpayer needed multiple *Crummey* powers in order to fully shelter the transfer in trust from gift tax on the basis of the annual exclusion.

The Service did not quibble with the ability of donor to claim an annual exclusion for gifts to the trust subject to withdrawal rights of the primary income beneficiaries. It took the position, however, that the amount of the transfer subject to the withdrawal rights of contingent remaindermen was not sheltered by the annual exclusion. In response, the tax court essentially assumed compliance with the economic benefit and documentation criteria, and analyzed the validity of the

158. *Id.* at 85.

159. *Id.* at 88.

160. 97 T.C. 74 (1991).

161. Note that in Cristofani, it was unlikely the contingent remaindermen would ever receive property from the trust. It was more likely that the trust proceeds would be paid to the trustor's children instead.

withdrawal rights in terms of the implementation criterion of the objective economic benefit test. It found "[t]here was no agreement or understanding between decedent, the trustees, and the beneficiaries that decedent's grandchildren would not exercise their withdrawal rights. . . ."[162] There were no facts, other than the absence of exercise of the withdrawal rights, to indicate an implied agreement.

Again, in *Kohlsaat v. Commissioner*,[163] a memorandum opinion, the tax court upheld the annual exclusion for *Crummey* withdrawal rights. The facts of *Kohlsaat* were similar to *Cristofani*, but with 16 contingent trust remainderpersons holding withdrawal rights.[164] The Service argued that the substance-over-form doctrine should apply in light of "understandings [that] existed between decedent and the 16 contingent beneficiaries . . . to the effect that the beneficiaries would not exercise their rights to demand distributions of trust property."[165] The Service contended that these understandings negated decedent's donative intent. The tax court rejected this argument and found no such understandings existed between decedent, trustees and contingent beneficiaries. The court found the beneficiaries offered several credible reasons for not exercising the withdrawal rights. In the context of the objective economic substance test, all three criteria, including the implementation criterion, were met.

In yet a second memorandum opinion, the Tax Court in *Holland v. Commissioner*,[166] reiterated its rejection of the Service's substance-over-form argument. In *Holland*, transferor did not possess sufficient liquid assets to make annual exclusion gifts to her three children, daughter-in-law and eight grandchildren. In order to make such gifts, transferor borrowed funds. Her son, acting as her agent, took twelve $10,000 checks written to the donees, negotiated a bank note for $120,000, executed a loan on behalf of donor and obtained the donees' endorsements on the checks. Her son deposited the checks in an agent account and purchased a $120,000 certificate of deposit, which was in turn pledged as security for the loan. The Service denied the gift tax annual exclusions on the basis that an

162. *Id.* at 77.

163. 73 T.C.M. (CCH) 2732, 1997 Tax Ct. Memo LEXIS 247 (1997).

164. The donor, thus, could have made a transfer of up to $160,000 free of any Federal estate or gift tax consequences. 1997 Tax Ct. Memo LEXIS 247 at 2.

165. *Id.* at 6-7.

166. 73 T.C.M. (CCH) 3236, 1997 Tax Ct. Memo LEXIS 356 (1997).

agreement existed among the donor and donees regarding use of the $10,000 transfers. The tax court again focused on whether there was any agreement that would prevent the donee's legal ability to use the $10,000. The tax court found no such agreement. It noted that no evidence indicated transferor would have refrained from making the transfer if a donee did not agree to invest in the certificate of deposit, and noted that because the family was investment oriented, they had agreed the best rate of return would be achieved by pooling their gifts. These objective facts indicated a legally enforceable withdrawal right, that was implemented by the transferor and beneficiaries.

The tax court in each of these decisions acknowledged the *Crummey* withdrawal rights were legally enforceable rights, and as such should be recognized as a transfer of a present interest even though it was unlikely the beneficiaries would ever in fact benefit from the transfers to the trust. The court in all three cases rejected the Service's argument that the donor and the contingent beneficiaries had an implied understanding that the beneficiaries would not exercise their rights, as demonstrated by the fact that they in fact did not exercise their withdrawal rights. The court in *Kohlsaat* indicated the beneficiaries had several credible reasons for not exercising the withdrawal rights, and stated: "The fact that none of the beneficiaries exercised their rights or that none of the beneficiaries requested notification of future transfers of property to the trust does not imply to us that the beneficiaries had agreed with decedent not to do so, and we refuse to infer any understanding."[167]

The tax court's decisions regarding the *Crummey* withdrawal right appropriately applied the common law of estate planning as developed in the United States Supreme Court decisions. Specifically, the United States Supreme Court in *Commissioner v. Noel*[168] and in *United States v. Byrum,*[169] as discussed above, emphasized the necessity of determining the legally enforceable rights to economic benefits granted by the applicable agreement or trust instrument. The legally enforceable rights determine the tax consequences of a transfer. So long as the beneficiary can legally enforce the withdrawal right, the beneficiary has received the right to the immediate possession of the transferred amount, and has met both the

167. 73 T.C.M. (CCH) 2732, 1997 Tax Ct. Memo LEXIS 247.

168. 380 U.S. 678 (1965); *supra* note 75.

169. 408 U.S. 125 (1972); *supra* note 79.

Gagliardi: Economic Substance in the Context of Federal Estate and Gift

economic benefit and documentation criteria. In order to obtain the benefit of the gift tax annual exclusion, the statute requires no more than the right to immediate possession. The courts also appropriately rejected the Service's argument that an implied agreement existed between the donor and beneficiaries against exercise of the withdrawal rights. The lack of exercise does not indicate a failure of the substance of the transaction to in fact follow its form as required by the implementation criterion. Only if the trustee had denied the exercise of the withdrawal right or if in fact the beneficiaries had agreed to refrain from exercising the right would the withdrawal right fail to satisfy the implementation criterion.[170]

B. THE FAMILY LIMITED PARTNERSHIP

Another popular estate planning technique is the use of the family limited partnership to transfer property at substantial wealth transfer tax savings. This planning technique requires a donor to contribute property to a limited partnership, and thereafter transfer limited partnership units to the donees.

1. Estate Planning Opportunities

The technique has several advantages to the donor: (1) the donor as general partner may retain some continued control over the transferred property, (2) the limited partnership may provide added creditor protection, (3) the donor may receive the benefit of the Federal gift tax annual exclusion and (4) the donor may obtain a valuation discount with respect to the transferred property. From a tax perspective the most significant advantage of this planning technique is the resulting minority and lack of marketability discounts, associated with the valuation of the limited partnership interests transferred. The combined discount in some cases can be as much as sixty-five percent, allowing a donor to transfer assets at thirty-five percent of the value of the assets owned by the family limited partnership.[171]

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170. Many estate planners specifically counsel their clients in writing regarding the risk that in fact a beneficiary may exercise a withdrawal right. They also counsel their clients to avoid any statements that would indicate an agreement, or even a mere request, that the right not be exercised.

171. *See* Adams v. United States, 2001-2 U.S. Tax Cas. (CCH) ¶ 60,418, 88 A.F.T.R.2d (RIA) 6057, 2001 U.S. Dist. LEXIS 13092 (N.D. Tex. 2001). (Court allowed a 20 percent minority interest discount, a 10 percent portfolio discount for poorly diversified assets, and a 35 percent lack of marketability discount to reflect lack of a ready market.)

In order to obtain Federal wealth transfer tax benefits offered by the family limited partnership, the donor contributes assets, such as business interests and real property, to a limited partnership, and the donor's children contribute cash. In exchange for the contribution, the donor and donor's children receive partnership interests; generally the donor receives general partnership and limited partnership interests, and the children receive limited partnership interests proportionate to their respective contributions.[172] Some donors also transfer partnership interests to a charity in an effort to obtain better estate tax results. The donor annually gifts limited partnership units up to the value of the Federal gift tax annual exclusion, and at the same time the donor, as a general partner, continues to manage the property of the limited partnership subject to applicable fiduciary duties.

Prior to October 9, 1990, the family limited partnership could be aggressively used to obtain Federal wealth transfer tax savings. The taxpayer could obtain deep minority and lack of marketability discounts.[173] The taxpayer also could obtain an

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172. Where the donor intends for children to join in the management of the transferred assets, the children also may receive general partnership interests in return for their contribution. At times, the donor will prefer to relinquish management rights completely, and receive in return only limited partnership interests.

173. The tax court memorandum opinion in *Harrison v. Comm'r,* 52 T.C.M. (CCH) 1306, T.C.M. (RIA) 87008, 1987 Tax Ct. Memo LEXIS 8 (1987), demonstrates the effectiveness of the limited partnership as an estate planning technique prior to 1990. In *Harrison* , decedent's son pursuant to a power of attorney transferred decedent's assets consisting of real estate, oil and gas interests and marketable securities to a Texas limited partnership. Decedent received a 1% general partnership interest and a 77.8% limited partnership interest. Decedent's sons contributed assets, as well, and received 10.6% general partnership interests. The partnership was created August 1, 1979 at a time when decedent was in poor health. Decedent died January 14, 1980. In an adversarial proceeding, the state court found that "the partnership constituted 'a means for the proper and necessary management of the properties of [decedent]' and that the partnership agreement was 'advantageous to and in the best interests of [decedent]'." 1987 Tax Ct. Memo LEXIS 8 at 5 n2. The estate reaped transfer tax savings based on (i) the lower value of the limited partnership interest and (ii) the lapse of decedent's liquidation right at death. During life a general partner could unilaterally liquidate the partnership and receive the fair value of his partnership interest, in this case $59,555,020. At decedent's death this liquidation right lapsed when decedent's general partnership interest automatically converted to a limited partnership interest valued, based on its minority position, at $33,000,000. (If *Harrison* had been decided under current law, Code section 2704 would have required that the lapsing right be ignored and that the more than $25 million difference be added to the gross estate.)

The Commissioner unsuccessfully asserted that the court should ignore "the effect the partnership agreement has upon decedent's limited partnership interest because the partnership agreement was an attempt to artificially depress the value of decedent's property for estate tax purposes." 1987 Tax Ct. Memo LEXIS 8 at 12. The court indicated the agreement should be ignored "only if there is no business purpose for

Gagliardi: Economic Substance in the Context of Federal Estate and Gift Tax

annual exclusion for gifts of limited partnership interests.[174] In addition, the Service acknowledged the transferor's gross estate would not include the value of any previously transferred limited partnership interests on the basis of Sections 2036 or 2038 of the Code because the general partner transferor owed a fiduciary duty to the limited partners.[175]

Effective for transfers occurring after October 8, 1990, Congress enacted special valuation rules that curtailed use of many of the estate freeze techniques where the donor and donor's family control the entity.[176] Now, in order to effectively use a family limited partnership, the terms of the partnership must comply with these special valuation rules. Even after enactment of the special valuation rules, taxpayers can achieve wealth transfer tax savings in the form of valuation discounts.

As with all Federal estate and gift tax statutes, the special valuation rules divide up rights associated with assets. The Code by its terms dictates the form that the limited partnership agreement must take in order to achieve a valuation discount for transfers of limited partnership interests. For example, if the family limited partnership agreement contains restrictions on liquidation rights not otherwise provided by applicable state law, the restriction is disregarded for gift tax valuation purposes.[177] Also, for example, if the partners enter into a restriction on sale, the restriction is disregarded unless it meets certain requirements of the Code.[178] If the family limited

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the creation of the partnership or if the agreement is merely a substitute for testamentary disposition." *Id.* at 12-13. The court found a business purpose. The partnership provided a vehicle for the necessary and proper management of decedent's properties. The court declined to find the agreement was a substitute for testamentary disposition because (i) the agreement applied to all partners, (ii) decedent received adequate consideration and (iii) there was no proof that the partnership was created other than for business purposes. *Id.* at 13-14. *See also* Estate of Watts v. Comm'r, 823 F.2d 483 (11th Cir. 1987).

174. *See* Priv. Ltr. Rul. 9415007 (Jan. 12, 1994); Priv. Ltr. Rul. 9131006 (April 30, 1991).

175. The Service issued a series of private letter rulings acknowledging that the fiduciary duties of the general partner would preclude inclusion of the transferred interests in the general partner transferor's gross estate. The Service based its reasoning on the United States Supreme Court holding in *Byrum v. Commissioner*, 408 U.S. 125, 137-43 (1972), *supra* at text accompanying note 79. Priv. Ltr. Ruls. 9415007 (Jan. 12, 1994); 9332006 (Aug. 20, 1992); 9310039 (Dec. 16, 1992); 9131006 (April 30, 1991).

176. I.R.C. §§ 2701-2704. In the context of the family limited partnership, the agreement and transfers must not violate the parameters of Code Section 2701, 2703 and 2704.

177. I.R.C. § 2704(b) (2002).

178. I.R.C. § 2703 (2002).

partnership agreement follows the correct form as prescribed by these Code provisions in fulfillment of the economic benefit and documentation criteria, and if the partners respect the legal rights of the partners as set forth in the agreement in fulfillment of the implementation criteria, courts should uphold the planning technique and its tax benefits based on the objective economic substance test.

The Service aggressively attacks the use of family limited partnerships based on these special valuation rules and on a substance over form argument. It has achieved varied success in this effort. As evidenced by the following discussion, the Service fails in its attack when the family limited partnership is structured so as to meet the three criteria of the objective economic substance test. The discussion also demonstrates the Service has succeeded in thwarting this planning technique only when either the documentation criterion fails because the transfers were inappropriately structured, or when the implementation criterion fails because the taxpayer has not respected the transaction and ignored legally enforceable partnership rights.

2. Successful Use of the Family Limited Partnership

The Service employs a multi-prong attack. It attacks the family limited partnership based on a failure to comply with each of the special valuation rules. It also attacks based on its subjective intent based test.

The Service began its most recent campaign against the aggressive use of family limited partnerships by issuing a series of technical advice memoranda.[179] The Service carefully chose to attack only those family limited partnerships susceptible to characterization as testamentary substitutes. In each of the technical advice memoranda, the partnerships were formed within months of death or after the donor had been diagnosed with a terminal illness.[180] The Service ruled that the formation of the family limited partnership lacked any business purpose, and that in substance it was nothing more than a testamentary transfer.[181] The Service analogized to the tax court's prior

179. Tech. Adv. Mems. 98-42-003 (July 2, 1998); 97-35-003 (May 8, 1997), 97-30-004 (Apr. 3, 1997); 97-25-002 (Mar. 3, 1997), 97-23-009 (Feb. 24, 1997), 97-19-006 (Jan. 14, 1997).

180. *Id.*

181. This is the same argument reiterated in recent I.R.S. Field Service Advice. *See*

decision in *Murphy v. Commissioner*[182] where the court disregarded the transfer of a minority interest in a corporation 18 days prior to decedent's death on the basis that taxpayer's sole purpose was tax avoidance and without any business purpose was merely a testamentary device. With the exception of *Murphy*, the Service has had little success with this argument in court. Courts generally recognize the legally enforceable rights granted by the partnership agreement, and acknowledge the likelihood of those rights impacting value of the partnership interests[183]

Courts also have rejected the Service's attack based on the special valuation rule that ignores for valuation purposes certain restrictions on the right to sell or use property.[184] The Service urges characterization of the family limited partnership agreement as such a restriction, and argues the family limited partnership should be ignored with the full value of the property contributed to the partnership taxed. The courts hold that recognition of the family limited partnership is appropriate where the limited partnership was properly formed under state law.[185] They find that the property to which the special valuation section applies is the partnership interest and not the property originally transferred to the partnership. This analysis essentially follows the lead of the United States Supreme Court, as embodied in the documentation criterion of the objective economic substance test, and recognizes the legally enforceable economic rights of the partners with respect to their partnership interests. The limited partnership agreement is the vehicle used to document the legally enforceable rights of the partners, just

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I.R.S. FSA 2000-49-003 (Sept. 1, 2000).

182. 60 T.C.M. (CCH) 645, T.C.M. (RIA) 90472, 1990 Tax Ct. Memo LEXIS 520 (1990).

183. Church v. United States, 2000 U.S. Dist. LEXIS 714 (W.D. Tex. 2000), *aff'd by unpublished opinion*, 268 F.3d 1063 (5th Cir. 2001). *See also* Estate of Strangi v. Comm'r (Strangi II), 293 F.3d 279, 282 (5th Cir. 2002) (recognizing economic substance of the partnership because it was unlikely a prospective purchaser would ignore the partnership). *Compare*, Estate of Murphy v. Comm'r, 60 T.C.M. (CCH) 645, T.C.M. (RIA) 90472, 1990 Tax Ct. Memo LEXIS 520 (1990).

184. I.R.C. § 2703(a)(2). The Code section excepts from its application those restrictions which are a bona fide business arrangement, not a device to transfer property for less than full consideration and comparable to similar arm's length transactions.

185. Estate of Strangi v. Comm'r (Strangi I), 115 T.C. 478 (2000), *aff'd in part and rev'd in part on other grounds*, (Strangi II) 293 F.3d 279 (5th Cir. 2002)(court adopted in full the tax court opinion regarding I.R.C. §2703); Church v. United States, 2000 U.S. Dist. LEXIS 714 (W.D. Tex. 2000), *aff'd by unpublished opinion*, 268 F.3d 1063 (5th Cir. 2001); Knight v. Comm'r, 115 T.C. 506 (2000).

as a trust agreement documents and creates legally enforceable rights of trust beneficiaries. The courts appropriately conclude the limited partnership agreement creates enforceable legal rights in the partners.

The courts have also rejected the Service's argument that choosing to use a term partnership, as opposed to an "at will" partnership, is an applicable restriction that should be ignored pursuant to the special valuation rules.[186] The limited partnership is formed for a term of years, for example 40, and because of the stated term the limited partners may not withdraw from the partnership until the end of the term. Such a restriction depresses the value of the limited partnership interest, and for this reason the Service argues that the partnership term amounts to an applicable restriction. The Code defines applicable restriction as one that effectively limits the ability to liquidate the entity and that lapses or can be removed alone or collectively by the donor or a member of the donor's family.[187] The tax court[188] and the Fifth Circuit[189] have held a term partnership that prevents withdrawal of the limited partner until the end of the term is not an applicable restriction. The tax court focused on the definition of applicable restriction as one that effectively limits the ability of the entity to liquidate, and distinguished liquidation from the inability of a limited partner to withdraw from the partnership.

The Fifth Circuit affirmed the tax court's holding, but did so based on a different analysis. In the case reviewed by the Fifth Circuit, the restriction could not lapse nor could liquidation occur without first obtaining the agreement of a charity that was also a partner. The courts focused on the plain language of the statute and rejected the Service's argument because the donor or family members could not alone or collectively remove the restriction or liquidate as required by the statute because they had to first obtain the agreement of the charity. The courts, thus, focused on the legal rights of the partners as granted under the partnership agreement, and found that the

186. *See* I.R.C. § 2704(b).

187. I.R.C. § 2704(b)(2)(A), (B) (Note that the statute provides an exception for any restriction imposed by Federal or state law and for any commercially reasonable restriction which arises as part of a financing arrangement with an unrelated party.)

188. Kerr v. Comm'r, 113 T.C. 449 (1999), *aff'd*, 292 F.3d 490 (5th Cir. 2002); Jones v. Comm'r, 116 T.C. 121 (2001); Knight v. Comm'r, 115 T.C. 506 (2000), Harper v. Comm'r, 79 T.C.M. (CCH) 2232, T.C.M. (RIA) 53939, 2000 Tax Ct. Memo LEXIS 242 (2000).

189. Kerr v. Comm'r, 292 F.3d 490 (2002).

economic benefits conferred complied with the statutory requirements. The planning strategy analyzed under Section 2704 of the special valuation rules meets the economic benefit and documentation criteria.

Additionally, the courts have rejected the Service's argument that, upon formation of the family limited partnership, the donor makes a gift of the difference between the value of the assets contributed to the family limited partnership and the value of the partnership interest received in return.[190] The tax court originally reasoned that even absent a business purpose a gift did not occur because the donor received in return interests in the partnership allowing the donor to maintain control of the partnership.[191] In a later decision, the tax court explained its earlier reasoning as follows: "The Court held that, because the taxpayer received a continuing interest in the family limited partnership and his contribution was allocated to his own capital account, the taxpayer had not made a gift at the time of contribution."[192] Accordingly, no economic benefit had been transferred sufficient to result in a gift tax.

So long as the donor and donees retain under the partnership agreement only those rights, and economic benefits, allowable by the Code the courts have upheld the planning technique and allowed a valuation discount on the transfer of limited partnership interests. It is when the transaction has not conferred legally enforceable economic benefits, or the beneficiaries have failed to economically respect the form that the Service has succeeded in limiting the tax savings of the transaction. The court decisions demonstrate the necessity of granting legally enforceable rights to the donees that fall within the parameters of the Code, and the necessity of meeting the three criteria of the objective economic substance test.

190. For example, in *Jones v. Commissioner*, 116 T.C. 121 (2001), the donor contributed property valued at $ 17,615,857 and received in return limited partnership interests valued at only $ 6,675,156. The Service contended the almost $9 million difference in value amounted to a gift.

191. Estate of Strangi v. Comm'r (Strangi I), 155 T.C. 478, 490 (2000), *aff'd in part rev'd in part,* (Strangi II), 293 F.3d 279, 282 (5th Cir. 2002)(adopted in full the reasoning of the tax court rejecting the Service's argument that a gift occurs on formation of the limited partnership).

192. Estate of Jones v. Comm'r, 116 T.C. 121, 127-28 (2001).

3. The Service's Successful Attacks

The court's decision in *Shepherd v. Commissioner*[193] demonstrates the importance of properly structuring and documenting the transaction. The Service won in *Shepherd,* where before it had failed in its argument that a gift occurs on the formation of the limited partnership. In *Shepherd,* decedent transferred lease land and bank stock to the family partnership, and by the terms of the partnership agreement the capital accounts of the donee partners increased proportionately based on the partners' prior interests in the partnership. In addition, the donor initially reported the gift as one of land, then amended the gift tax return to report the gift as one of limited partnership interests for which a valuation discount was claimed. The court held that the gift of land to the partnership was an indirect gift to the partners in light of the concurrent increase in the donee partners' capital accounts. The court focused on the legal rights transferred, and indicated it was compelled to determine the tax consequences based on those rights. The majority opinion declined to re-characterize the transaction based on the donor's intent that partnership interests be transferred, as would the dissenting opinion. In dicta, the majority indicated it would have held differently if the donor had instead formed the partnership, transferred the land, and only then transferred partnership interests to the donees. Unfortunately, legal rights to "partnership" interests had not been transferred. The plan failed to satisfy the documentation criterion.

Court decisions have also emphasized the importance of enforceable legal rights in the determination of whether the transfer is one of an assignee interest in a limited partnership or a limited partnership interest. Ostensibly, an assignee interest is worth less than a limited partnership interest. An assignee typically has no legal right to participate in management decisions, and only has the right to the distributions that the limited partner would otherwise be entitled. The courts have valued the transferred interests as an assignee interest in the partnership where the partners adhere to the legal rights conferred on an assignee as opposed to a partner.[194] However,

193. Shepherd v. Comm'r, 155 T.C. 376, 385-86 (2000), *aff'd* 283 F.3d 1258, 1261 (11th Cir. 2002).

194. *See, e.g.,* Estate of Adams v. United States, 218 F.3d 383 (5th Cir. 2000); Estate of Nowell v. Comm'r, 77 T.C.M. (CCH) 1239, T.C.M. (RIA) 99015, 1999 Tax Ct. Memo LEXIS 15 (1999).

where the transfers were designated as transfers of limited partnership interests, and the partners had not enforced the formal legal steps required for admission of partners, the court held the value should be based on a transfer of limited partnership interests.[195] Again, the plan failed to satisfy the documentation and implementation criteria.

The Service has also successfully challenged the family limited partnership on the basis of an implied agreement between the donor and the donee that the donor's actual use of the property would not change. Courts have held that, in order to achieve wealth transfer tax savings intended by a transfer, the donor and donee must not ignore the documented legal rights by implied agreement as demonstrated by the facts of the case.[196] For example, in *Estate of Schauerhamer v. Commissioner*[197] the donor transferred limited partnership interests to her children, but nevertheless continued to deposit the partnership profits in her personal bank account and use partnership profits in excess of her proportionate partnership interest. The tax court held the transferred limited partnerships includible in her gross estate because the facts indicated an implied agreement to retain the benefit of the transferred interests.[198] This case indicates the importance of respecting the legal rights conferred by the partnership agreement so as to give economic substance to the form of the transaction, the implementation criterion.

The tax court in a recent memorandum opinion, *Estate of Strangi v. Commissioner*,[199] also found an implied agreement to retain the benefit of the transferred interest. In *Strangi*, decedent's attorney in fact formed a family limited partnership two months prior to decedent's death. The attorney in fact transferred to the partnership about 98 percent of decedent's assets, including the residence, other real estate, cash, securities, insurance policies, an annuity, receivables, and partnership interests. In return, decedent's estate received a 99

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195. Kerr v. Comm'r, 113 T.C. 449 (1999), *aff'd*, 292 F.3d 490 (5th Cir. 2002).

196. *See, supra* text accompanying note 93.

197. 73 T.C.M. (CCH) 2855, 1997 Tax Ct. Memo LEXIS 276 (1997).

198. The court included the transferred interests in her gross estate based on I.R.C. § 2036. *See also* Estate of Reichardt v. Comm'r, 114 T.C. 144 (2000); Thompson v. Comm'r, 84 T.C.M. (CCH) 374, T.C.M. (RIA) 54890, 2002 Tax Ct. Memo LEXIS 254 (2002); Estate of Harper v. Comm'r, 83 T.C.M. (CCH) 1641, T.C.M. (RIA) 54745, 2002 Tax Ct. Memo LEXIS 127 (2002).

199. (Strangi III) T.C. Memo. 2003-145, 2003 Tax Ct. Memo LEXIS 144 (2003). *See* discussion of *Strangi I* and *Strangi II* at text accompanying footnotes 185, and 191.

percent limited partnership interest, and a 47 percent interest in the corporate general partner. Decedent's children contributed property in return for a 53 percent interest in the corporate general partner. Subsequently decedent's children contributed a 1 percent shareholder interest in the general partner to a charity. The four children of decedent and decedent comprised the board of directors of the corporate general partner, and by a signed unanimous consent named decedent's attorney in fact as the corporate president pursuant to a broad management agreement. Numerous distributions were made from the partnership correlating in value to expenses incurred by decedent, with corresponding distributions to the general partner. In addition decedent continued to reside in the residence contributed to the partnership, but did not in fact pay rent. Instead rent simply accrued on the books of the partnership and was not paid to the partnership until well after decedent's death. The court included the assets of the limited partnership in decedent's gross estate based on numerous grounds.[200] First, the court found an implied agreement to

200. Each ground was based on inclusion under either I.R.C. §2036(a)(1) or (a)(2)(2003). I.R.C. Section 2036(a) states:

> "The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death – the possession or enjoyment of, or the right to the income from, the property, or the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom."

The opinion assumes the decedent made a "transfer" that would trigger application of I.R.C. Section 2036. In *Strangi* decedent contributed assets to the partnership and received in return limited partnership interests representing the value of the assets contributed. Decedent had not gratuitously transferred any of decedent's limited partnership interests nor any interest in the corporate general partner to a third party. Decedent could not "transfer" interests to himself. In an earlier tax court memorandum opinion, the court declined to apply I.R.C. Section 2036 based on contributions of partnership interests to a business trust taxed as a corporation. Estate of Michelson v. Comm'r, 37 T.C.M. (CCH) 1543, T.C.M. (RIA) 78371, 1978 Tax Ct. Memo LEXIS 143 (1978). The contribution of property to an entity in exchange for an interest in the entity, without more, should not trigger application of I.R.C. Section 2036. Taken to its logical conclusion, an analysis that applies I.R.C. Section 2036 based on formation of a business entity would require inclusion in the gross estate of the value of the underlying assets of every business entity formed by a decedent. To do otherwise would require the court to analyze decedent's intent in forming the partnership, and send the court down the slippery slope of determining a decedent's tax avoidance motive, a tangent that the Supreme Court has warned against.

retain the income from the assets based on the distributions made to cover decedent's extraordinary expenses and the continued occupancy of the residence without payment of cash rent.[201] These objective facts indicated a failure of the implementation criterion. Second, the court indicated that by entering into the management agreement with decedent's attorney in fact, decedent retained the legally enforceable right to income from the assets contributed to the partnership, a right that would cause inclusion of retained assets in the gross estate.[202] Third, the court found a legally enforceable right of decedent, through his attorney in fact, in conjunction with the other interest holders to designate the persons who will possess the income from the assets transferred to the partnership.[203]

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201. By not paying cash rent, decedent was essentially treating the residence as if he owned it and had not transferred it to the partnership. Likewise, by receiving distributions from the partnership each time decedent incurred an extraordinary personal expense, decedent essentially treated the property as if it were his own and not owned by the partnership.

202. In arriving at its conclusion, the court outlines the structure of the family limited partnership. It concludes: "When distilled to their most essential terms, the governing documents gave [decedent's attorney in fact] authority to specify distributions from SFLP, which is entirely consistent with his authority under the 1988 power of attorney." Based on these documents the court observed: "[O]ur analysis . . . of the express documents suggests inclusion of the contributed property under section 2036(a)(1) based on the "right to the income" criterion, without need further to probe for an implied agreement regarding other benefits such as possession or enjoyment."
The court's reasoning based on the documentation criterion assumes without analysis that a "right" to income was retained by naming the decedent's attorney in fact, who stands in decedent's shoes, as president of the corporate general partner. The United States Supreme Court in *Byrum* specifically rejected such an argument. *See* discussion at text accompanying note 81. The Supreme Court stated:

> "The term 'right,' certainly when used in a tax statute, must be given its normal and customary meaning. It connotes an ascertainable and legally enforceable power. . . . Here, the right ascribed to Byrum was the power to use his majority position and influence over the corporate directors to 'regulate the flow of dividends' to the trust. That right was neither ascertainable nor legally enforceable and hence was not a right in any normal sense of that term."

408 U.S. 125, 136-137 (1972) (This portion of the Court's analysis was not overruled by the anti-Byrum amendment, as discussed at note 86.) Like in *Byrum*, the fact that decedent's attorney in fact held management authority over the trust did not necessarily confer on decedent a "legally enforceable right" to the income of the limited partnership, especially in light of duties owed by the president to the corporate general partner and to the limited partnership.

203. The tax court, thus, alternatively would include the assets of the family limited partnership in decedent's gross estate based on application of I.R.C. Section 2036(a)(2). The court found that decedent's attorney in fact, who stands in the shoes of decedent, possessed, in conjunction with others, the legally enforceable right to determine the timing of income distributions from the family limited partnership, a right found to cause inclusion of trust assets in *United States v. O'Malley*, 383 U.S. 627 (1966). To arrive at its conclusion, the tax court needed to distinguish the Supreme Court's holding

Essentially, under the court's second and third grounds for gross estate inclusion, the formation of the partnership failed the documentation criterion because pursuant to the tax court's interpretation of Section 2036 of the Code, the documents did not allocate rights to economic benefits in a manner as required by the statute to exclude the assets from the gross estate.

The Service's success in *Hackl v. Commissioner*[204] also demonstrates the importance of actually granting the legal rights under the partnership agreement necessary to obtain the hoped for tax benefit. The tax court in *Hackl* denied the gift tax annual exclusion for gifts of membership interests in a family limited liability company. It found that the donees of the limited partnerships did not receive a present interest as required by the Code; in other words, the donees did not have the right to immediate possession of the economic benefit. In its analysis, the Tax Court focused on the inability of the donee to convert the interest in the limited liability company to cash without first obtaining the approval of the donor of the gift, in the donor's capacity as manager. The donee could not withdraw the donee's capital account and obtain the value of the entity interest. Also, the donee could not sell the donee's interest in

in *Byrum*, especially because the Service had previously issued private letter rulings that rejected application of Section 2036 based on the *Byrum* decision. *See* Priv. Ltr. Ruls. 94-15-007 (Apr. 15, 1994) and 93-10-039 (Mar. 12, 1993); Tech. Adv. Mem. 91-31-006 (Aug. 2, 1991). *Byrum* essentially held, in part, that Section 2036 would not apply in the context of a business corporation because the decedent as a majority shareholder owed fiduciary duties to the minority shareholders that prevented him from holding a legally enforceable right to do designate distribution of the income.

The court distinguishes *Byrum* on the basis of legal and economic constraints on the powers of the donor in *Byrum* not present in *Strangi*. Those legal and economic constraints include: (1) payment of corporate dividends to an independent trustee, who in turn had discretion to pay income, (2) the exigencies of an operating business that precluded complete control over distribution of income, and (3) the existence of unrelated minority shareholders with significant holdings. The tax court indicated: "First, the Supreme Court's opinion in *United States v. Byrum*, . . . provides no basis for "presuming" that fiduciary obligations will be enforced in circumstances divorced from the safeguards of business operations and meaningful independent interests or oversight. Second, the facts of this case belie the existence of any genuine fiduciary impediments to decedent's rights." The tax court also states: "Intrafamily fiduciary duties within an investment vehicle simply are not equivalent in nature to the obligations created by the *United States v. Byrum* . . . scenario." This analysis is extremely troubling and could have far reaching impact. A fundamental principle in estate planning is that the existence of an enforceable legal right or duty is sufficient without proof of its exercise. This principle underlies many estate planning techniques including transfers subject to *Crummey* powers and transfers subject to ascertainable standards. The tax court's analysis proves to much. Regardless of the familial relationship of the parties involved, the legally enforceable fiduciary duties remain.

204. 118 T.C. 279 (2002).

the limited liability company without approval, but could only transfer an assignee interest in the limited liability company. In dicta, the court indicated that the annual exclusion would have been allowed if the donee could have done either of those: withdraw the donee's capital account or sell the donee's interest subject to a right of first refusal. The plan in *Hackl* failed to meet both the economic benefit and documentation criteria for obtaining an annual gift tax exclusion.

These decisions, in which the Service successfully attacked the family limited partnership comply with the analysis of the objective economic benefit test. The donor must transfer economic benefits, that are legally enforceable under the limited partnership agreement. Those economic benefits must not violate the special valuation rules. Finally, the donor and donees must respect the legally enforceable economic benefits conferred. The form and the objective economic substance of the transaction must coincide. One without the other is insufficient to achieve wealth transfer tax benefits.

VII. ADVICE TO THE ESTATE PLANNER

Despite the inappropriateness of the Service's intent based economic substance approach, the Service's argument has impacted even those court decisions that in the final analysis reject an intent based economic substance approach.[205] The Service's argument impacts court opinions because the court must address each argument made by a party in its brief. For this reason, an estate planner must consider the Service's position when structuring an estate plan.

Specifically recent court decisions have discussed the health of the decedent just prior to the transfer. The Service has urged courts to look upon death bed transfers with disfavor, as did the tax court in *Murphy*,[206] the case most heavily relied upon by the

205. The Service's argument is reflected most recently in the Tax Court memorandum opinion issued by Judge Nim in Estate of Harper v. Comm'r, 83 T.C.M. (CCH) 1641, T.C.M. (RIA) 54745, 2002 Tax Ct. Memo LEXIS 127 (2002). The objective manifestations of the partners indicated a failure of the implementation criterion. Nevertheless the court went on to state: "Hence, not only the objective evidence concerning HFLP's history but also the subjective motivation underlying the entity's creation support an inference that the arrangement was primarily testamentary in nature. . . .[T]he subjective impetus prompting decedent to form HFLP centered on what would happen to his property after death." The tax court ignored Supreme Court precedent urging a rejection of subjective motivation as a basis for determining estate tax consequences.

206. 60 T.C.M. (CCH) 645, T.C.M. (RIA) 90472, 1990 Tax Ct. Memo LEXIS 520

Service when it argues economic substance. Deathbed transfers smack of testamentary intent. In response, the tax court has taken into account the fact that a taxpayer had undergone heart bypass surgery and suffered seven heart attacks.[207] In contrast, the United States District Court in Texas has distinguished the instance where the taxpayer's cancer was in remission and she had recently purchased new clothing.[208] The emphasis by some courts on the health of the taxpayer at the time of the estate planning transfer indicates the need for estate planning lawyers to inquire as to the health of their client and, to the extent possible, document the state of the client's good health.

In response to the Service's intent based economic substance argument, recent court decisions also address the underlying purpose of the transfer, and analyze whether the transfer accomplishes a legitimate purpose. When the transfer involves interests in a family business, the Service has emphasized the need for a valid business purpose. The courts have accepted as a valid business purpose the need to keep the family business in the family.[209] Recognition of the need to keep the family business under family control comports with the donative purpose that underlies all estate planning transfers – to pass family wealth to family members. In anticipation of the Service's argument, estate planners should document the business purpose underlying the estate planning transfer, and should ensure that the objective economic substance of the transfer accomplishes the stated business purpose.

Also, following the tax court's most recent memorandum decision, a cautious planner also would avoid using a business entity to hold passive investment interests.[210] The tax court has indicated in dicta that it will apply the estate tax Code differently if the contribution to the family limited partnership or other entity is of active business interests as opposed to

(1990).

207. Estate of Schuler v. Comm'r, 80 T.C.M. (CCH) 934, T.C.M. (RIA) 54171, 2000 Tax Ct. Memo LEXIS 465 (2000), *aff'd* 282 F.3d 575 (8th Cir. 2002).

208. Church v. United States, 2000-1 U.S. Tax Cas. (CCH) ¶ 60,369, 85 A.F.T.R.2d (RIA) 804, 2000 U.S. Dist. LEXIS 714 (W.D. Tex. 2000), *aff'd without published opinion*, 268 F.3d 1063 (5th Cir. 2001).

209. *Id.* (noted as a valid business purpose the need to keep the working ranch in name of taxpayer's and her descendants); Estate of Schuler v. Comm'r, 80 T.C.M. (CCH) 934, T.C.M. (RIA) 54171, 2000 Tax Ct. Memo LEXIS 465 (2000), *aff'd*, 282 F.3d 575 (8th Cir. 2002) (in this case the actual transfers did not support the business purpose of keeping the stock in the names of those children active in the family business).

210. Strangi v. Comm'r, T.C. Memo. 2003-145, 2003 Tax Ct. Memo. LEXIS 144 (2003).

passive investment assets The tax court's basis for differing treatment lies in what it sees as solely a tax avoidance purpose when using passive investment assets.

Finally, the estate planner also should ensure that the estate plan complies with the objective economic substance test, based on Supreme Court precedent as set forth in this article. The donor must transfer a legally enforceable economic benefit. To the extent the legal rights result in the correct form as required by the statute and to the extent the parties to the transfer respect those legal rights, the estate planning technique should achieve the desired wealth transfer tax savings. Enforceable legal rights give economic substance to the form of the transaction. The historical emphasis on objective economic substance reflects the structure of the Federal estate and gift tax. The Code taxes transfers based on rights retained and rights transferred. It is appropriate for a court to trace the flow of property in order to determine the rights in fact retained and transferred, and to tax the transaction accordingly. The estate planner should emphasize to clients the need for respecting in economic substance the transfer of economic benefit and the accompanying legally enforceable rights.

VII. CONCLUSION

The Federal estate and gift tax applies to the transfer of valuable property rights. The Code determines when the transfer of rights are taxable. It, thus, directs the form and the substance that a transaction must take in order to minimize tax. Substance is determined by tracing the legal rights associated with economic benefits transferred. This can be done most easily by following the actual money trail; and, absent a money trail, by determining who in fact holds the legally enforceable rights to the property. The objective economic substance test, as set out in the three criteria, ensures that a transfer of value actually occurs, and allocates tax burdens accordingly.

Donative purpose underlies transfers subject to the estate and gift tax. The primary objective of most donors is to give the greatest amount of assets possible to their children and grandchildren. This necessarily means that the transaction must be structured to minimize wealth transfer tax. Because tax minimization necessarily underlies each estate planning transfer, criteria other than intent to avoid or minimize tax are necessary to define economic substance in the estate planning context. The objective economic substance test provides parameters ensuring the actual transfer of economic benefit from the transferor to the beneficiary. Actual transfer of economic benefit is the "substance" taxed by the estate and gift tax provisions of the Code.